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TAX FLASH NEWS

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Testing and certification services are taxable as FTS unless such services are not made available as prescribed under a relevant tax treaty

Recently, the Delhi Bench of Income-tax Appellate Tribunal (the Tribunal) in the case of Havells India Ltd[1] (the taxpayer) dealt with the issue of taxability of testing and certification services provided by foreign entities. The taxpayer had made payments to various foreign entities (US, the Netherlands, China and Germany) towards testing and certification of its products. The Tribunal held that services provided to the Netherlands and US based entities are not taxable as Fees for Included Services (FIS) in India since such services do not satisfy the 'make available' condition specified under Article 12 of the India-US tax treaty as well as under the India-Netherlands tax treaty. However, payments for such services to the German as well as Chinese entities are taxable as Fees for Technical Services (FTS) in India.

Further the Tribunal held that 30 per cent disallowance under Section 40(a)(ia) of the Income-tax Act, 1961 on payments made to a resident without deduction of tax at source does not apply to payments made to a non-resident. It cannot be treated as discrimination between resident and non-resident.

The Tribunal also held that the payment of non-compete fees are capital expenditure on which the depreciation is not available.

Facts of the case

The taxpayer is engaged in the manufacturing of switchgears, energy meters, cables and wires, electrical fans, compact fluorescent lamp, etc. and also in the trading of luminaries lighting fixtures and exhaust fans. During the Assessment Year (AY) 2004-05, the taxpayer acquired 24 per cent of equity capital in an Indian company. In terms of the same, the taxpayer entered into a non-compete agreement with the company, partners, directors and shareholders of the company whereby the taxpayer agreed to pay the non-compete fees. These non-compete fees were claimed by the taxpayer as revenue expenditure while computing its taxable income.

Further, the taxpayer made payment to various foreign entities[2] towards testing and certification of its products. The foreign entities had a specialised knowledge and facility for carrying out testing and necessary certification, which was required to be utilised in the manufacturing activity of the taxpayer. These are country specific certifications which are mandatory for sale in those respective countries. The taxpayer claimed that such testing was done through machines not involving any human intervention in testing and hence the same, do not, constitute technical service warranting deduction of tax at source.

The Assessing Officer (AO) treated the non-compete fees as capital expenditure because such payment resulted into a benefit of enduring nature in the hands of the taxpayer. The AO held that the payments for testing fees were taxable under Section 9(1)(vii). With respect to the applicability of tax treaty, the AO held that the taxpayer had 'made available' such services and hence it was taxable as FTS/Fees for Included Services (FIS) under the India-Netherlands and the India-US tax treaty. The AO also held that the testing fees were taxable under the India-China and the India-Germany tax treaty where make available clause does

[1] Havells India Ltd. v. DCIT- (ITA No. 6072 & 6073/Del/2010 and 466/Del/2011, AY 2007-08) - Taxsutra.com
Note: The Tribunal in this decision has dealt with several other issues. However, this flash news deals only with some of the key issues.

[2] The Netherlands, US, China and Germany

not exist. Consequently, the payment was disallowed under Section 40(a)(i). The Commissioner of Income-tax (Appeals) [CIT(A)] upheld the order of the AO.

Tribunal's decision

Testing fees paid to the US and the Netherlands entities

The taxpayer contended that payment to testing agencies in U.S and the Netherlands were already decided in favour of the taxpayer by the Tribunal in taxpayer's own case for AY 2005-06 and 2006-07. The Tribunal for AY 2005-06 had held that as per the Article 12(4)(b) services provided can be taxable as FIS if it will 'make available' such technical knowledge, experience, skill, know-how or processes to the recipient of those services. The fact that the provision of the services may require technical input by the person providing those services does not per se mean that the technology or technical knowledge etc., are 'made available' to the persons purchasing that services. Thus, services provided does not satisfy the 'make available' clause, hence, services are not chargeable to tax in India.

Relying on the said decision, in the present case, the Tribunal held that the services do not satisfy the 'make available' test and hence do not constitute FIS under the India-US and the India-Netherlands tax treaty. Consequently, the payment to US/Netherlands entities cannot be disallowed under Section 40(a)(i).

Testing fees paid to the Chinese entity

With respect to the payment made to the Chinese entity, the taxpayer had contended that in terms of Article 12 of the tax treaty, the meaning of FTS is restricted to only services performed in India, based on the 'place of performance test'.

The Tribunal relied on the decision in the case of Ashapura Minichem Ltd[3] where on a perusal of Article 12 of the India-China tax treaty, it was observed that (i) The FTS income shall be deemed to accrue or arise in the source country, when the payer is resident of that country (ii) It is the 'provision of services' and not necessarily the 'performance of services' in the source country which attracts the taxability. It was observed that the expression 'provision for services' used in the India-China tax treaty, is much wider in scope than the expression 'provision for rendering of services' used in other tax treaties. Hence, for the FTS income to be taxable in India, the rendition of services in India is not necessary, it is sufficient that the services are utilised in India. Accordingly, the FTS was taxable in India under the India-China tax treaty.

Relying on the above decision, the Tribunal in the present case observed that Article 12(4) of India-China tax treaty does not provide that services should be rendered in India to qualify as FTS. Accordingly, the disallowance in the case of Chinese entity was confirmed.

Payment to the German entity

In case of payments made to the German entity, the Tribunal held that services provided by the foreign entity was technical in nature and thus taxable under the India-Germany tax treaty.

Amendment in Section 40(a)(ia)

The taxpayer contended that in view of amended provisions of Section 40(a)(ia)[4] disallowance should be restricted to 30 per cent while applying the provisions of Section 40(a)(i). Further, the taxpayer made an alternative contention that the amendment made under Section 40(a)(ia) amounts to discrimination with respect to the payment made to non-residents compared to the payment made to a resident.

The Tribunal held that the legislature thought fit in its own wisdom to restrict the disallowance when the payment is made to a resident. However, there was no such amendment made in the provisions of Section 40(a)(i) dealing with payment to a non-resident. The Tribunal cannot add or insert a condition that was not envisaged in a provision of the law by the lawmakers. It amounts to rewriting the provisions of the law itself for which there is no authority.

The Tribunal rejected the alternate contention made by the taxpayer with respect to the discrimination between resident and non-resident. The Tribunal observed that both are different provisions to be applied in different situations. One for payment made by a resident to a non-resident under Section 40(a)(i) and another by a resident to a resident under Section 40(a)(ia). The Tribunal did not find that there was any discriminatory treatment given to a non-resident entity.

Non-compete fees

The taxpayer had acquired trademark and design and also obtained the manufacturing facilities of an Indian entity which prevented its related firm and all its shareholders from not competing in the business of manufacturing of electrical items. The non-compete charges paid by the taxpayer were part of the whole transaction of acquisition of a brand, obtaining manufacturing facilities of an Indian entity on cost plus basis and prevented all the shareholders and their family members in entering into competition with the taxpayer. Therefore, it cannot be said that the non-compete fees were paid merely to obtain the manufacturing facilities. The taxpayer in sum and substance acquired the whole Polstar business of the Indian entity and warding off the competition of the taxpayer for a long time. Various decisions[5] relied on by the taxpayer were distinguishable on facts of the present case.

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[3] Ashapura Minichem Ltd v. ACIT [2010] 40 SOT 220 (Mum)

[4] As per Section 40(a)(ia), any sum payable to a resident, which is subject to deduction of tax at source, would attract 30 per cent disallowance if it is paid without deduction of tax at source or if tax is deducted but is not deposited with the Central Government till the due date of filing of return.

5 Carborandum Universal Ltd. v. JCIT. [2012] 26 taxmann.com 268 (Mad), Coal Shipments (P.) Ltd. v, CIT. [1971] 82 ITR 902 (SC), Eicher Ltd. v. CIT. [2008] 173 Taxman 251 (Del), CIT v. Max India Ltd. (ITA No. 193/ 2013 dated 6 August 2018)

Though the taxpayer had produced various judicial precedents on the allowability of non-compete fees as revenue expenditure, however it missed out Judicially binding precedent of the Delhi High court in case of Sharp Business System[6] which clearly covered the issue in favour of the tax department. The Delhi High Court held that the non-compete fee paid by the taxpayer to its erstwhile partner as a consideration for not setting up any business of selling marketing and trade of electronic office products for a period of seven years amounted to capital expenditure and the same was not allowable under Section 37(1). In view of the decision of the jurisdictional High Court, the non-compete fees paid by the taxpayer was a capital expenditure.

The taxpayer made alternative contention stating that if the non-compete fee was held as capital in nature then depreciation on the same was to be allowed under Section 32(1)(ii). Relying on the decision of the Delhi High court in case of Sharp Business System, it was held that non-compete fee was not eligible for depreciation under Section 32.

Our comments

The issue with respect to the taxability of testing fees has been a subject matter of debate before Courts/Tribunal.

The Kolkata Tribunal in the case of Outotec (Finland) Oy[7] held that income from testing and other services is taxable in India even if technical services of testing were performed outside the country. The Tribunal observed that though the process of testing was conducted outside India, the payment in question was not for the process but was for the results of testing which were used in India. Therefore, the services provided by the taxpayer are taxable under Article 12(5) of the India-Finland tax treaty. Further, Chennai Tribunal in the case of Cooper Standard Automotive India Pvt. Ltd[8] held that the payment for testing and development charges was in the nature of FTS and it was taxable under the Act as well as under the India-Italy tax treaty.

The Tribunal in the present case has held that the India-China tax treaty does not provide that services should be rendered in India to qualify as FTS. Therefore, the testing and certification services provided by the Chinese entity were taxable under the India-China tax treaty. Such services were technical in nature and therefore also taxable under the India-Germany tax treaty. However, payment to the Netherlands and US based entities were not taxable as FTS under the respective tax treaties since the services do not satisfy the 'make available' conditions.

The Delhi Tribunal in the case of Mitsubishi Corporation India Pvt Ltd[9], relying on the non-discrimination clause under the India-Japan tax treaty, held that a different tax treatment to the foreign enterprise per se is enough to invoke the non-discrimination clause in the India-Japan tax treaty. Accordingly, the Tribunal deleted the disallowance under Section 40(a)(i)[10].

The Tribunal in the present case has observed that Section 40(a)(i) and Section 40(a)(ia) are different provisions to be applied in different situations. Therefore, the non-resident entity was not discriminated on this ground .

[6] Sharp Business System v. CIT [2012] 254 CTR 233 (Del)
[7] Outotec (Finland) Oy v. DCIT (ITA No. 2601/Kol/2018)
[8] Cooper Standard Automotive India Pvt Ltd v. ACIT (ITA No. 785/Mds/2014)

[9] Mitsubishi Corporation India Pvt. Ltd v. DCIT (ITA No. 5042/Del/11)
[10] Disallowance under Section 40(a)(ia) cannot be made in respect of payments made to a resident taxpayer, even in case of non-deduction of tax at source, as long as related payments are taken into account by the recipients in computation of their income, and taxes in respect of such income are duly paid and income tax returns are duly filed under Section 139(1).

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