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TAX FLASH NEWS

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Sub-contracting charges paid to Chinese subsidiary are taxable as FTS

Recently, the Bangalore Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Infosys Limited[1] held that sub-contracting charges paid to a Chinese subsidiary are taxable as Fees for Technical Services (FTS) under the Income-tax Act, 1961 (the Act) as well as under the India-China tax treaty (the tax treaty). The Tribunal observed that post amendment to Section 9(1)(vii), it is no longer necessary that the services must be rendered in India. Further, irrespective of the situs of technical services rendered, under the tax treaty, the FTS will be deemed to have been accrued in the tax jurisdiction in which the person making the payment is located.

Facts of the case

The taxpayer, an Indian company, is engaged in the business of the development and export of computer software and related services. The taxpayer has a wholly owned subsidiary in China (ITCL). Pursuant to sub-contracting agreement dated 1 October 2005 and 1 August 2011, the taxpayer, sub-contracted certain overseas work in China to ITCL.

The taxpayer made payment of sub-contracting charges to ITCL. The said payments were made without deduction of tax at source. The taxpayer's contention was that the payments were not chargeable to tax under the Act or under the tax treaty.

The Assessing Officer (AO) held that the taxpayer was an `assessee in default' for not deducting tax at source under Section 195. The AO held that the payments made to ITCL were taxable under Section 9(1)(vii) as FTS and liable for tax deduction under Section 195. The CIT(A) confirmed the order passed by the AO.

[1] Infosys Limited v. DCIT [IT(IT)A No.4/Bang/2014] - Taxsutra

Tribunal's decision

The issue of tax deduction at source under Section 195 on the payment made by the taxpayer to ITCL, whether it comes within the purview of Section 9(1)(vii) is squarely covered by the decision of the Mumbai Tribunal in the case of Ashapura Minichem Limited[2] where it was held that the retrospective amendment to Section 9, by the Finance Act, 2010 and substitution of Explanation to the said section, negated the effect of the Supreme Court's decision in the case of Ishikawajima Harima Heavy Industries Ltd.[3]. The Mumbai Tribunal had held that it was no longer necessary that, in order to invite taxability under Section 9(1)(vii), the services must be rendered in Indian tax jurisdiction.

Further, the Mumbai Tribunal held that irrespective of the situs of technical services having been rendered, under the India-China tax treaty, the FTS will be deemed to have been accrued in the tax jurisdiction in which the person making the payment is located.

The reliance on Ishikawajima Harima Heavy Industries Ltd. by the taxpayer was not correct in view of the retrospective amendment to Section 9(1)(vii) read with the Explanation. In view of the amendment, rendering of services in India is no more required. Since a final product after utilisation of partial services rendered by ITCL being exported by the taxpayer, the test of services utilised in India was satisfied.

The taxpayer taken a plunge into interpretation of Article 12(4) and juxtaposing it with Article 12(6), without any regard to Article 12(2). Article 12(1) is dealing with primary right to tax which lies with

[2] Ashapura Minichem Limited v. ADIT [2010] 40 SOT 220 (Mum)
[3] Ishikawajima Harima Heavy Industries Ltd. v. DCIT [2007] 288 ITR 408 (SC)

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resident country. As per Article 12(2), the secondary right to tax FTS lies with the source country in which such payments arise. It is well accepted that specific prevails over generic items. Further, Article 12(4) is primarily dealing with the definition of the term FTS and therefore there is a necessity to read down `accrual' concept as referred thereunder to the extent there is conflict with Article 12(6). The provisions of Article 12(4) and 12(6) have to be read harmoniously but not antagonistically by applying well accepted and well settled canons of construction of statutes i.e. doctrine of harmonious construction. As Article 12(6) deems that the payment arises in the country of payer, thereby attracting provisions of Article 12(2) of the tax treaty.

For the purpose of taxation, the taxpayer is different from its subsidiary in China. The taxpayer had submitted that it has procured the contracts from overseas clients and the same is sub-contracted to ITCL. Now, the taxpayer was trying to portray that the activities carried on by Chinese subsidiary was business activity of the taxpayer, which was not correct. Merely because the clients were outside India did not mean that the taxpayer was carrying on business outside India.

In this context, the Delhi High Court in the case of Havells India Ltd[4] held that on payment made to a US company for certification facilitating export, the source of income was within India and the taxpayer was not covered within the exception of Section 9(1)(vii)(b).

The taxpayer had claimed benefit of Section 10A/10B for the export of software from the specified units from India. Hence, it was not open to the taxpayer to contend that no services were rendered or utilised in India. The taxpayer relied on the Kerala High Court decision in the case of Device Driven (India) Pvt. Ltd[5]. The decision was not applicable to the facts of the present case, as the services rendered by ITCL were utilised by the taxpayer in India before exporting the software.

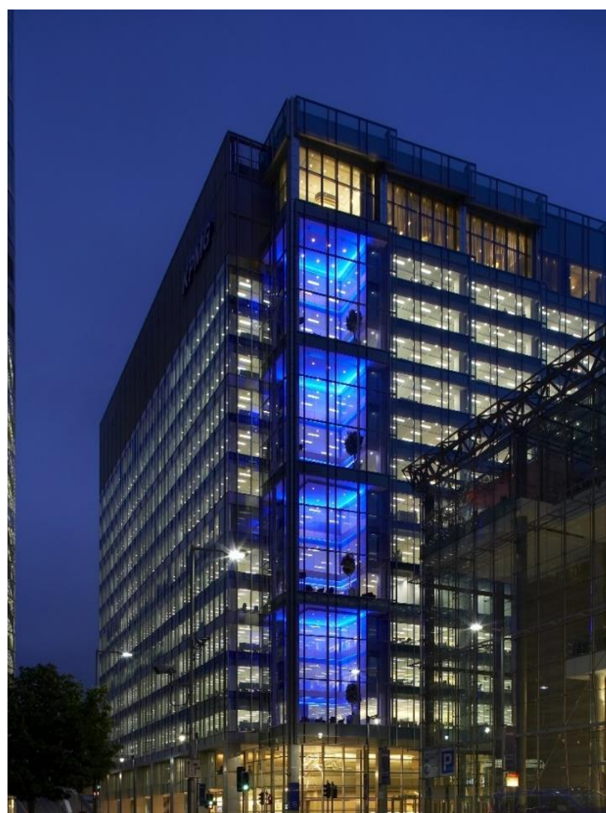
The taxpayer had raised an alternate claim for the AY 2011-12. It was submitted that certain sub-contracting charges were paid on 1 May 2010, which was prior to the enactment of the Finance Act, 2010. Therefore, it was contended that the taxpayer cannot be made liable for the tax liability on the said payment under Section 201(1) and 201(1A). The Tribunal restored the issue of taxability with regard to sub-contracting charges paid on 1 May 2010, to the files of the AO. The AO is directed to take a decision in accordance with law after affording a reasonable opportunity of being heard to the taxpayer.

Our comments

The Supreme Court, in the case of Ishikawajima-Harima Heavy Industries Ltd., held that the concept of territorial nexus is fundamental in determining the taxability of any income in India and that the income from offshore services would not be taxable in India merely because the activities are rendered in relation to an Indian turnkey project. Subsequent to this decision, an Explanation under Section 9 was specifically amended to provide that interest, royalty and FTS income of a non-resident shall be deemed to accrue or arise in India whether or not the non-resident has a residence or place of business or business connection in India or the non-resident has rendered services in India.

The Mumbai Tribunal, in the case of Ashapura Minichem Limited, held that the retrospective amendment to Section 9, by the Finance Act, 2010 and substitution of Explanation to the said section, negated the effect of the Supreme Court's decision in the case of Ishikawajima Harima Heavy Industries Ltd. Further, for taxability under Section 9(1)(vii), it is not necessary that the services must be rendered in India.

The Bangalore Tribunal, in the instant case, has held that sub-contracting charges paid to the Chinese subsidiary are taxable as FTS under the Act as well as under the India-China tax treaty. The Tribunal observed that subsequent to the amendment to Section 9(1)(vii), it is no longer necessary that the services must be rendered in India.



[4] CIT v. Havells India Ltd. [2013] 352 ITR 376 (Del)
[5] Device Driven (India) Pvt. Ltd. v. CIT 126 taxman.com 25

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