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TAX FLASH NEWS

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Payments to foreign entities for training of pilots and crews are not taxable in India

Recently, the Bangalore Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Kingfisher Airlines Ltd[1] (the taxpayer) held that payments made by an Indian airline company to foreign entities for training of its pilots and cockpit crews outside India are not taxable as royalty under the Income-tax Act, 1961 (the Act) or under respective tax treaties[2].

Further such payment to Dubai entity will fall under the business income article in the absence of Fees for Technical Services (FTS) Article in the India-UAE tax treaty. Since, Dubai entity had no Permanent Establishment (PE) in India, such payments were not taxable in India. With respect to payments to German and Singapore entities, the Commissioner of Income-tax (Appeal) [CIT(A)] held that such payments were FTS and were taxable in India because of the retrospective amendment to Act. The Tribunal observed that for the year under consideration, such amended provisions did not exist and it was not possible for the taxpayer to foresee an obligation to deduct tax at source by a retrospective amendment to the Act. Accordingly, the taxpayer was not treated as an 'assesse in default' under Section 201(1) of the Act to the extent of the payment relating to FTS and consequent liability towards interest under Section 201(1A) of the Act was deleted.

Facts of the case

The taxpayer, an Indian company, is in the business of airline. During the Assessment Year 2007-08 and 2008-09, the taxpayer sent its personnel for training of pilots and cockpit crew to Dubai, Germany and Singapore respectively. The taxpayer entered into an agreement with the entities in these countries for simulator and other flight training devices for the purpose of training to its cockpit crews and pilots, etc. The non-resident entities was to provide various trainings to the taxpayer's personnel as per the taxpayer's requirement.

The taxpayer made payments to these non-residents without deduction of tax at source. The Assessing Officer (AO) observed that the main objective of the agreement was to lease the flight training equipments i.e. simulator to the taxpayer. Rates and payment terms were determined on the basis of usage of simulators. The charges also includes the other costs like costs of the instructors and facilities etc. Therefore, basic nature of payment was for use of equipment which also includes charges of instructors and trainers.

In respect of payment to Dubai resident, a part of the payments for usage of equipment (i.e. simulator) and part of the charges for imparting of information concerning industrial, scientific and commercial experience knowledge or skill therefore would be in the nature of 'royalty' under Section 9(1)(vi) of the Act and India-UAE tax treaty.

In respect of payment to German residents, the AO held that the non-resident has to make available simulator to the taxpayer for the purpose of training. The charges paid/payable were mainly for usage of simulator and for imparting information etc. falls within the definition of royalty under Section 9(1)(vi) of the Act. The AO also held that payment would also fall under the category of FTS as per Article 12(4) of the tax treaty.

In respect of payment to Singapore resident, the AO held that payments were made by the taxpayer for use of simulators and towards training of its employees. The trainers and instructors mainly are involved in imparting information to the cockpit crew and pilots. Therefore the payments were in the nature of royalty and FTS both under the Act and under the India-Singapore tax treaty and therefore were chargeable to tax in India.

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[1] Kingfisher Airlines Ltd v. DDIT (ITA No. 86 & 87/Bang/2011) – Taxsutra.com
[2] India-UAE tax treaty, India-Germany tax treaty, India-Singapore tax treaty

Thus, the taxpayer was under an obligation to deduct tax at source on the aforesaid payments made to the non-resident.

The Commissioner of Income-tax (Appeals) [CIT(A)] held that the payment for usage of the simulators at the time of training the cabin crew/pilots cannot be regarded as payment for royalty. As far as the payment to non-resident can be regarded as FTS was concerned, the CIT(A) held that with respect to payment made to Dubai resident, as per the India-UAE tax treaty, there was no clause defining FTS and therefore such payments can be regarded only as income from business. There was no PE of the UAE concern in India and accordingly even if any income had arisen in India that can be taxed only in UAE and not in India since Article 12 contains only provisions for royalty and not for FTS. Accordingly, the CIT(A) held that FTS paid to the UAE concern was not liable for tax in India and thus provisions of Section 195 were not applicable.

In respect of payment made to German entity, the taxpayer relied on the tax treaty provisions to claim that payments cannot be said to be FTS because there was no territorial nexus between India and the place where the services were rendered. Further in respect of payment to Singapore entity the taxpayer claimed that the payments do not satisfy the make available condition under the India-Singapore tax treaty and therefore not taxable as FTS. The CIT(A) relying on AAR decision InterTek Testing Services India (Pvt) Ltd.[3] did not accept the argument of the taxpayer that no part of the consideration can be said to be payment in nature of FTS. To justify his conclusion that FTS was taxable in India, the CIT(A) also made a reference to the amendment to Section 9 of the Act[4] where it is stated that for the purposes of this section, where income is deemed to accrue or arise in India under clauses (v), (vi) and (vii) of sub-section (1), such income shall be included in the total income of the non-resident, 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 CIT(A) further observed that there was a amendment to Explanation to Section 195[5] of the Act, thus territorial nexus for taxing a receipt as FTS was no longer required to be satisfied and therefore the payments to non-residents in the nature of FTS was taxable in India.

The CIT(A) directed the AO to exclude the payment made towards usage of simulators and only the rest of the payments made towards training expenses alone have to be regarded as FTS and taxed accordingly.

Tribunal's decision

Taxability of simulator fee

A flight simulator is a device that artificially re-creates aircraft flight and the environment in which it flies, for pilot training, design, or other purposes. It includes replicating the equations that govern how aircraft fly, how they react to applications of flight controls, the effects of other aircraft systems, and how the aircraft reacts to external factors such as air density, turbulence, wind shear, cloud, precipitation, etc. Flight simulation is used for a variety of reasons, including flight training (mainly of pilots), the design and development of the aircraft itself, and research into aircraft characteristics and control handling qualities. Therefore, flight simulator is essential part of training imparted to the pilots and crew of aircraft.

The fact that the charges for use of the simulator is separately quantified on hourly basis does not mean that the taxpayer is hiring the same or making payment for a right to use the same. Without the imparting of training by the instructors, the hiring of simulator on its own does not have any purpose. Therefore, it cannot held that the taxpayer paid royalty for use of simulator.

Payment to Dubai entity

The question whether the payment was FTS does not arise because FTS clause is missing in the India-UAE tax treaty. The settled position of law was that in the absence of a clause in a tax treaty not dealing with a particular item of income, the same should not be regarded as residuary income but income from business.

However, in the absence of Permanent Establishment (PE) of the non-resident in India, the same cannot be taxed. The Tribunal relied on the decision of ABB FZ-LLC[6].

Retrospective amendment

The CIT(A) upheld the order of the AO only the ground of a retrospective amendment. The tax department relied on the Explanation 2 to Section 195 of the Act amended by the Finance Act of 2012 with retrospective effect from 1 April 1961 to hold that the taxpayer was liable to deduct at source.

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[3] InterTek Testing Services India (Pvt) Ltd [2008] 307 ITR 418 (AAR)
[4] By the Finance Act, 2010 with retrospective effect from 1 June 1976
[5] By Finance Act 2012 with retrospective effect from 1 April 1961

[6] ABB FZ-LLC v. ITO [2016] 75 taxmann.com (Bang)

The Tribunal observed that for the AY 2007-08 and 2008-09, such provision did not exist. It was not possible for the taxpayer to foresee an obligation to deduct tax at source by a retrospective amendment to the law. In such circumstances, the question that arises for consideration is as to, whether a liability to deduct tax at source can be fastened on the taxpayer on the basis of a retrospective amendment to the law. The amendment made by the Finance Act with retrospective effect, which was passed in the year subsequent to the year under consideration, should not be considered for penalising the taxpayer by treating him as an 'assessee in default'.

The CIT(A) erred in holding that FTS was taxable in India only because of the retrospective amendment to the law and erred in not holding that the liability to deduct tax at source arises at the time of making payment and therefore there would be no obligation to deduct tax at source. Accordingly, taxpayer cannot be treated as an 'assesse in default' under Section 201(1) of the Act to the extent of the payment relating to FTS and consequent liability towards interest under Section 201(1A) of the Act was to be deleted.

Our comments

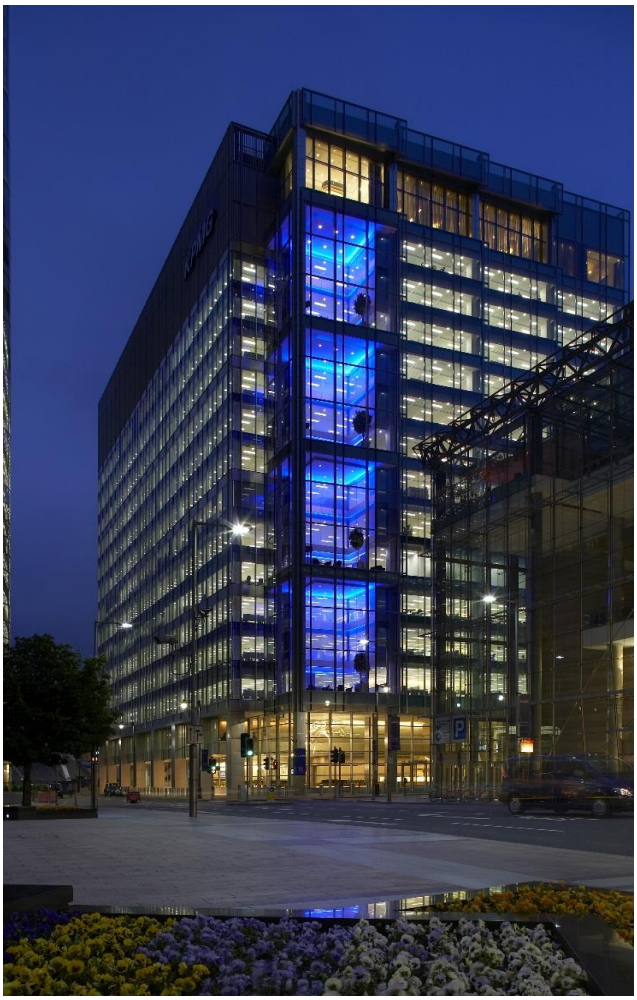
The Courts/Tribunal have extensively dealt with the issue with respect to taxability of services in the absence of specific FTS article in a tax treaty. Some of the Courts[7] have held that in absence of FTS article in the tax treaty, services should be taxable under 'Business Profit' article if the taxpayer is having PE in India. If the taxpayer does not have PE in India such services would not be taxed in India. However, the Authority for Advance Rulings (AAR)[8] observed that since there is no specific article for taxation of FTS in the tax treaty, it would be directly governed by Article 22 of the tax treaty which is residuary article in the tax treaty. The AAR has not examined the 'Business Income' article for such income.

The Bangalore Tribunal in the case of Spice Telecom[9] observed that since services provided by the taxpayer were not covered under India-Mauritius tax treaty, the same were not taxable in India.

The Tribunal in the present case held that since India-UAE tax treaty not dealing with a particular item of income, the same should not be regarded as residuary income but income from business. However, in the absence of PE in India, the business income cannot be taxed in India.

With respect to taxation of payment for simulator, the Tribunal observed that without imparting of training by the instructors, the hiring of simulator on its own does not have any purpose. Therefore, payment for use of simulator, cannot be treated as royalty.

With respect to payments to German and Singapore entities, the CIT(A) had held that such payments were FTS and were taxable in India because of the retrospective amendment to Act. The Tribunal observed that for the year under consideration, such amended provisions did not exist and it was not possible for the taxpayer to foresee an obligation to deduct tax at source by a retrospective amendment to the Act. Accordingly, the taxpayer was not treated as an 'assesse in default' under Section 201(1) of the Act to the extent of the payment relating to FTS and consequent liability towards interest under Section 201(1A) of the Act was deleted.



[7] McKinsey Business Consultants v. DDIT [2015] 54 taxmann.com 300 (Mum), Bangkok Glass Industry Co. Ltd. v. ACIT [2013] 34 taxmann.com 77 (Mad),
[8] Lanka Hydraulic Institute Ltd [2011] 11 taxmann.com 97 (AAR)
[9] Spice Telecom v. ITO [2008] 170 Taxman 82 (Bang)

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