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TAX FLASH NEWS

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Testing and certification related services are not taxable as FTS under the India-US tax treaty

Recently, the Surat Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Star Rays[1] (the taxpayer) dealt with the taxability of diamond testing and certification services. The Tribunal held that testing and certification related services provided by the US company to the taxpayer do not 'make available' technical knowledge, experience, skills, etc. and hence such services are not taxable as Fees for Technical Services (FTS) under the India-US tax treaty (tax treaty). The US company had the experience of testing and certification and there was no imparting of its experience in favour of the taxpayer. The taxpayer had only received a report of certification. The activity of issuing a certificate cannot be said to be imparting of information by the person who possesses such information.

With respect to tax treaty benefit, the Tribunal observed that the service agreement was between the taxpayer and the US company. The beneficiary of the remittance was erroneously specified as a Hong Kong entity. The taxpayer had furnished valid Tax Residency Certificate (TRC) and Form-10F and hence the taxpayer was entitled to the benefits of the tax treaty.

Facts of the case

The taxpayer, an Indian partnership firm, is engaged in the business of cutting, polishing and export of diamonds. The taxpayer entered into a customer services agreement with the US company. The US company certifies the taxpayer's diamonds and the same are exported piece by piece.

During the Assessment Year 2015-16, the taxpayer made remittance for diamond testing certification charges to the US company. The payment was made to of US company's offshore bank account in Hong Kong. The taxpayer contended that the US company was the ultimate recipient of the funds paid for diamond testing and certification services. Therefore, the India-US tax treaty should apply to the transaction.

The Assessing Officer (AO) on reference to the declaration made in Form 15CA/CB, observed that the diamonds were shipped to Hong Kong for testing, gradation and certification. Such testing related work was carried out in Hong Kong. The testing services were rendered by Hong Kong Laboratory. The payments were made in a bank account located in Hong Kong as per the condition of payment. The state of source was not obliged to give up the taxing rights over the passive income in the nature of FTS merely because the income was paid direct to a recipient of a state with whom the state of source had concluded a tax treaty. The AO observed that the India-US tax treaty benefits could not be granted as the payment was made to Hong Kong based entity and there was no tax treaty with Hong Kong. The payment was deemed to be income chargeable to tax in India under Section 9 of the Income-tax Act, 1961 as FTS.

The Commissioner of Income-tax (Appeals) [CIT(A)] held that as per tax residency certificate and PE certificate, the recipient is a resident of the USA. The testing and grading certification for diamonds and other articles are issued by the US company. Thus, the taxpayer is entitled to the benefit of the India-USA tax treaty, which contains 'make available' clause under the FTS article. It was observed that there was no parting of information concerning industrial, commercial or scientific experience by the US company when it issued the grading certificate. The US company has the experience of grading and report certificate and there was no imparting of its experience in favour of the taxpayer. This activity of issuing a certificate cannot be said to be imparting of information by the person who possesses such information. The grading report did not 'make available' technical knowledge and skills to the taxpayer. Thus the payment to the US company was not taxable as FTS under the tax treaty.

[1] ITO v. Star Rays [ITA No.725/SRT/2018 (AY 2015-16)] – Taxsutra.com

Tribunal's decision

Agreement of certification with the US company

Diamonds certificate was issued by the US company. Such certification was considered as a standard benchmark by the trade as well as by the customers and all intellectual property rights in the certification belong to the US company. On perusal of such agreement, it was observed that Hong Kong, Dubai and Israel were the 'take in window' where articles were delivered. However, the services agreement is between the taxpayer and US company. Copy of grading certificate was also issued by the US company. Due to a clerical mistake, the beneficiary of the remittance was erroneously specified as a Hong Kong entity.

The Tribunal upheld the order of the CIT(A), where it was observed that the taxpayer had furnished a confirmation letter from HSBC Bank that the payments were made by the taxpayer to the US company.

Eligibility of tax treaty benefits

TRC is an important document to avail the benefit of the tax treaty in respect of payment made to a non-resident as per Section 90(4). The taxpayer had furnished a copy of TRC obtained from the US tax authority and Form-10F as required under Section 90(4) and 90(5). As per TRC and Form-10F, the taxpayer was entitled to the benefit of the tax treaty.

Taxability as FTS

The activity of grading of certification is merely the application of knowledge and experience of a professional team assigned for a particular set of diamonds which were offered for certification or for grading. There was no parting of information concerning industrial, commercial or scientific experience by the US company when it issued the grading certificate. The US company had the experience of grading and report certificate and there was no imparting of its experience in favour of the taxpayer. The taxpayer had only received a report of certification. This activity of issuing a certificate cannot be said to be imparting of information by the person who possesses such information.

The grading report did not 'make available' technical knowledge, experience, skill, etc. to the taxpayer.

Reference was made to the decision of the Delhi Tribunal in the case of GE Energy Management Services Inc.[2] and the decision of the Karnataka High Court in the case of De Beers Minerals (P) Ltd[3].

Accordingly, testing and certification related services were not taxable as FTS under the tax treaty.

Our comments

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

The Delhi Tribunal in the case of Havells India Ltd[4] held that testing and certification services provided to the Netherlands and the US-based entities were not taxable as fees for included services in India since such services did not satisfy the 'make available' condition under Article 12 of the India-US as well as India-Netherlands tax treaty. However, payments for such services to the German as well as Chinese entities were taxable as FTS in India.

In the present case, the Tribunal has held that testing and certification-related services do not 'make available' technical knowledge, experience, skills, etc. and hence the same were not taxable as FTS under the tax treaty.

In the instant case, such services were rendered by the US company; however, payments were made in Hong Kong based bank of the US company. The Tribunal observed that the services agreement was between the taxpayer and US company and due to clerical mistake the beneficiary of the remittance was erroneously specified as a Hong Kong entity. Further, the taxpayer had furnished a copy of TRC as well as Form-10F. Therefore, the taxpayer was entitled to the benefits of the tax treaty.

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[2] GE Energy Management Services Inc. v. ADIT [2022] 135 taxmann.com 173 (Del)
[3] CIT v. De Beers India Minerals (P) Ltd [2012] 21 taxmann.com 214 (Kar)
[4] Havells India Ltd. v. CIT [2021] 188 ITD 439 (Del)

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