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Tax Flash News

10 July 2024

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Service fee arising from a single contract can be bifurcated into business income and fees for technical services for taxation purposes

Executive summary

In a case where a non-resident has a permanent establishment (PE) in India, the service fee attributable to such PE is taxable in India. There has been a controversy with regard to the taxability of remaining service fee (i.e., that part of fee which is not so attributable). The issue is whether such remaining service fee, if qualifies as fee for technical services (FTS), continues to be taxable on gross basis or is outside the purview of taxation in India.

The Delhi High Court in the case of *International Management Group (UK) Limited*[1] held that service fee arising from a single contract can be bifurcated for the purposes of the taxation. The fee to the extent attributable to the PE is taxable as business income. The remaining part of fee could be taxable as FTS subject to the fulfillment of the conditions prescribed in the relevant provision. In the instant case, as the services did not satisfy 'make available' test of the FTS article under the India-UK tax treaty, the services fee was not taxable in India by way of the FTS.

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[1] *International Management Group (UK) Limited* v. *CIT* (ITA 218/2017): Source - Taxsutra

Relevant provisions of the treaty

As per the business profits article[2] of the India-UK treaty (the treaty), if a UK resident carries on business in India through a PE, the profits attributable to that PE are taxable in India.

However, where business profits include an item of income which is dealt with separately in any other (specific) article of the treaty, then the provisions of that other article (such as FTS article) shall prevail over the business profits article for that item of income[3] (referred to as 'subsidiarity rule' in the international commentaries).

In this regard, there is a specific article in the treaty dealing with the taxation of the royalties and FTS on gross basis.

In this regard, FTS is defined to mean the consideration for rendering the technical or consultancy services which 'make available' technical knowledge, experience, skill know-how, processes etc. (make available test).[4]

However, if the right, property or contract in respect of which the royalties or FTS are paid is effectively connected with the non-resident's PE in India, it is business profits article (and not the FTS article) which is applicable. (effective connection provision).

The term PE is, *inter alia*, defined to include the furnishing of services other than those taxable under FTS article (Service PE).[5]

Relevant provisions of the Act

Under the Income-tax Act, 1961 (the Act), the FTS is defined to mean consideration for rendering any managerial, technical or consultancy services (there is no make available test under the Act). Secondly, the FTS is not taxable in India where it is payable in respect of services utilised in a business carried on by the Indian resident (payer of FTS) outside India or for earning of income from a source outside India (FTS exception).[6]

The Finance Act, 2010 made an amendment in the Act to provide that FTS could be taxable in India whether or not the services have been rendered in India.[7]

[2] Article 7 of the treaty

[3] Article 7(9) of the treaty

[4] Term 'Royalties' is also separately defined in the treaty

[5] Article 5(2)(k) of the treaty

[6] Section 9(1)(vii)(b) of the Act

[7] The amendment was given retrospective effect from 1 June 1976

Facts of the case

The taxpayer, a resident of the UK, entered into a service agreement with the Board of Control for Cricket in India (BCCI) for providing advisory and managerial services in relation to the establishment, commercialisation, and operation of the cricket league i.e., Indian Premier League (IPL).

The taxpayer admitted that it had a Service PE in India and thus offered to tax only the income attributable to that PE by way of business income.

The Revenue argued that the income remaining after attribution to the PE, should be taxable as FTS.

Taxpayer's contentions

Bifurcation of income

The composite consideration arising from one single and indivisible contract cannot be bifurcated into business income and FTS. Once the income attributable to the PE has been taxed in India as business income, the balance receipts (i.e., which is not so attributable) were not liable to be taxed as FTS.

Interplay between business profits article and FTS article under the treaty

Even if it is assumed that the services were technical in the nature, it would be taxable in accordance with the business profits article (and not FTS article) as the service agreement was effectively connected to the Indian PE.

The Service PE clause is applicable for services not taxable under the FTS article. Thus, once the Service PE clause has been applied in respect of the services provided by the taxpayer, such services cannot be taxed as FTS.

Make available test not satisfied

The taxpayer was providing the services continuously for more than ten years. This proved that there was no transfer of technical knowledge, etc. to enable the BCCI to perform the activities independently in the future. Thus, the service fee is not covered by the definition of FTS under the treaty.

FTS exception under the Act applicable

For some of the years under consideration, the IPL event was organised outside India[8]. For those years, the taxpayer's services were rendered and utilised outside India and the source of the BCCI's income was outside India. Thus, the service fee is covered by the FTS exception and not taxable in India under the Act.

Revenue's contentions

Interplay between business profits article and FTS article under the treaty

Merely because a part of the income was attributed to the Indian PE and was offered to tax as business income, it does not mean that the taxpayer would be exempted from the FTS article.

There was a distinction between the services and functions performed by the UK office of the taxpayer and by the Indian PE. The UK office's services were not effectively connected with the Indian PE, and thus the income from such services should be taxed as FTS.

The applicability of Service PE clause for the services rendered in India does not preclude the application of FTS article for services rendered outside India by the UK office.

Make available test under the treaty fulfilled

The services provided by the taxpayer involved specialised knowledge and skills which were made available to the BCCI in the form of findings from research, know-how relating to commercial rights, processes and workflow, experience etc. It enabled the BCCI to organise the cricket league on its own.

Mere fact that the tenure of the agreement spanned over ten years would not be a factor relevant to determine whether the make available test is fulfilled or not.

The FTS article does not prescribe a duration over the course of which the knowledge, etc. may be made available. In initial years, some business requires handholding by a consultant till the time the recipient of service acquires adequate knowledge to function independently.

[8] South Africa and the United Arab Emirates

FTS exception under the Act

After the amendment by the Finance Act, 2010, the services rendered by the taxpayer outside India were also taxable as FTS under the Act.

High Court's decision

Interplay between business profits article and FTS article under the treaty

The PE clause neither serves as a head of taxation nor is concerned with the characterisation or categorisation of income. It enumerates the criteria and circumstances in which a non-resident's presence and activities in India would be sufficient to constitute a PE.

Merely because a part of the income was attributable to functions performed by the Service PE, the Revenue was not estopped in law from examining whether income other than that attributable to the Service PE could be subjected to tax under other articles of the treaty such as FTS article.

Bifurcation of income

The bifurcation of income earned by a non-resident is envisaged by the subsidiarity rule[9]. The rule envisages the situations where the business profits comprise of more than one item of income and requires the Revenue to deduce and identify the most appropriate article to tax each item of income separately.

Multiple streams of revenue or income may potentially be embodied within a single contract and each stream may warrant separate consideration for the purposes of tax characterisation. It ensures that the appropriate tax treatment is applied to each type of income.

The bifurcation would prevent an over-generalisation of income under a single category. The business profits article is not intended to function as an overarching, all-encompassing provision that subsumes all forms of income irrespective of their intrinsic character.

[9] Article 7(9) of the treaty

Effectively connected with PE

The phrase ‘effectively connected’ has been a subject of divergent and varying interpretations with different authorities and commentaries offering distinct perspectives. However, in the context of the instant case, it was unnecessary to delve into this issue. The issue was kept open for a more appropriate case where its interpretation and application are the core issues.

Make available test under the treaty not fulfilled

The taxpayer was required to carry out research every year to ascertain improvements in the management and execution of the league. Merely because research material was shared with the BCCI, or the service rendered by the taxpayer was utilised by the BCCI cannot mean that the BCCI was enabled or equipped with the special knowledge of the taxpayer.

The continued provisioning of service over a substantial period of time proved that the make available test was not satisfied.

FTS exception under the Act applicable

For some of the years under consideration where the IPL was held outside India, the taxpayer’s services were utilised for earning income by the BCCI from a source outside India, and thus was covered by the FTS exception. The amendment by the Finance Act, 2010 would not override the FTS exception.

Our comments

The High Court in this decision upheld the bifurcation of income under a single contract and allowed a part of income to be taxed as business profit while the remaining part as FTS. The subsidiarity rule requires ‘item of income’ to be taxed under the specific applicable article.

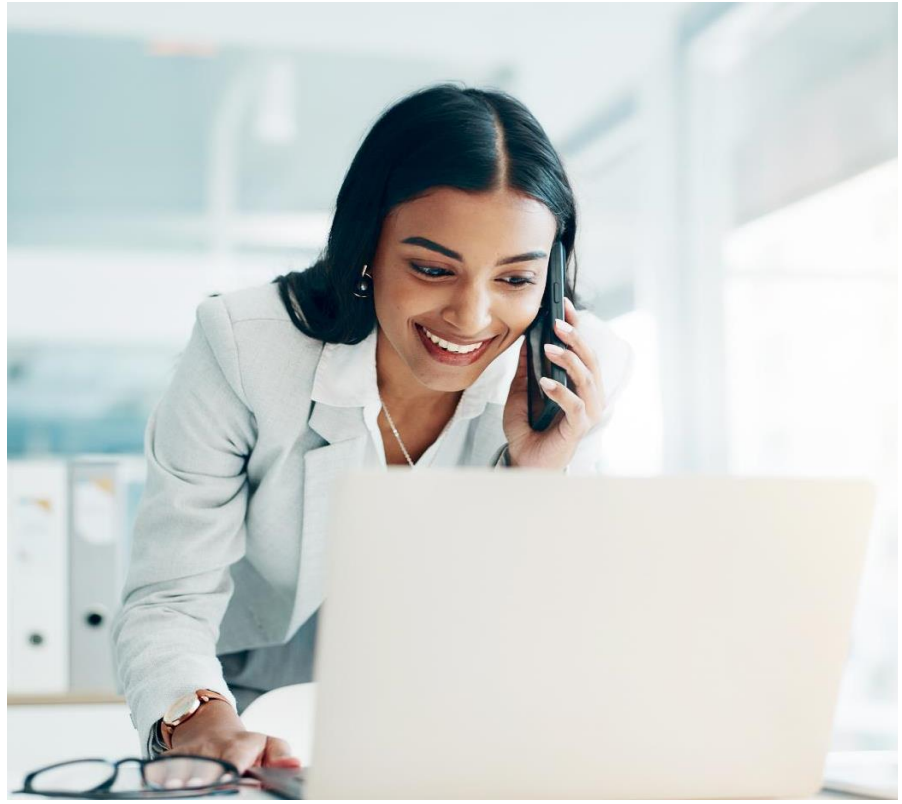
The terms of agreement in each case need to be evaluated to analyse whether the service fee arising under a single and indivisible contract comprises of various items of income or whether such fee is one item of income which can not be bifurcated for the purposes of taxation.

In the instant case, the FTS was not taxable based on the applicable legal provisions and the facts of the case. However, this decision could be significant in other cases where the remaining service fee (i.e., after attributing to the PE) continues to be taxable in India as FTS under the Act as well as under the applicable treaty (say, where there is no make available test in the FTS definition under the treaty).

The High Court has not dealt with the interpretation of the effective connection provision. The provision precludes the application of royalties/ FTS clause itself if the right, property or contract in respect of which the royalties or FTS are paid is effectively connected with the PE.

It may be noted that under the India-UK treaty, it is the right, property or contract (and not the royalties/ FTS) which needs to be effectively connected with the PE. This is in contradiction to effective connection provision under the UN MC[10] which requires FTS to be effectively connected with the PE. The relevant provision under the India-USA treaty precludes the application of the FIS[11] clause if the FIS is attributable to the PE (instead of 'effectively connected' with the PE). It will be interesting to see how the courts will interpret the variation in the languages used in different tax treaties.

The Australian Federal Court in a decision in the context of India-Australia tax treaty held that the purpose of effective connection provision is to relieve the source State from the limitation on taxing rights imposed by royalty article[12] and allow to tax such income under the business profits article. The purpose is not to disentitle the source State from any taxing rights where business profits article would not otherwise give such taxing rights.



[10] Article 12A(4) of UN Model Double Taxation Convention 2021

[11] Fees for included services

[12] Under India-Australia treaty, the service fee is included in the definition of royalties for the purposes of taxation

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