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TAX FLASH NEWS

29 April 2022

Reimbursement of salaries paid to seconded employees is not taxable as FTS

Executive Summary

Recently, the Bangalore Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Toyota Boshoku Automotive India Pvt Ltd[1] (the taxpayer) dealt with the taxability of reimbursement made by the taxpayer to its non-resident group company towards the salary of seconded employees. The Tribunal held that there was an employer-employee relation between the taxpayer and the seconded employees. The taxpayer deducted tax at source under Section 192 of the Income-tax Act, 1961 (the Act) on the entire amount of salary paid to all the seconded employees and paid the same to the credit of the Central Government. The taxpayer only reimbursed a part of the salary cost of the seconded employees to the Japanese entity that was already subjected to TDS. Therefore, there was no requirement to deduct tax at source while making such reimbursement to the Japanese entity.

If the seconded employees were regarded as employees of the taxpayer in India, then such reimbursement would not be in the nature of FTS, but it would be in the nature of 'salary'. Therefore, the reimbursements are not chargeable to tax in the hands of a Japanese entity, and there would be no obligation to deduct tax at source at the time of making payment under Section 195.

Facts of the case

The taxpayer, an Indian company, is engaged in manufacturing of automobile components such as seats, door trims and interiors for passenger cars. The taxpayer is also a licensed manufacturer carrying out manufacturing activities using the technology and technical know-how, obtained from a Japanese entity. The taxpayer entered into a transaction with Associated Enterprise (AE) whereby the taxpayer made reimbursement of part of expat salary. The taxpayer deducted tax under the head salary on the amount payable to the seconded employees, whereas on the reimbursed amount, no tax was deducted. The Assessing Officer (AO) passed the draft assessment order, incorporating certain additions, including reimbursement of expenses.

The Dispute Resolution Panel (DRP) issued directions that the reimbursement of salary of the expat employees was in the nature of FTS, and these were the employees of the AE, as per the agreement between the AE and the taxpayer. Subsequently, the AO passed a final assessment order making disallowance in the hands of the taxpayer. Aggrieved, the taxpayer filed an appeal before the Tribunal.

Tribunal decision

Under the Act, irrespective of the residential status of the employee, salary would be taxable in India, if it was for the services rendered in India, which was deemed to have been earned in India. In the case of seconded employees, if they were tax residents of a country with whom India has a tax treaty, Indian tax authorities right to tax salary income would depend on the terms of such tax treaty.

In OECD Model Commentary, Article 15 provides for the right of taxation, in so far as salaries are concerned, between the source state and the residence state. Article 15(1) of OECD Model Convention lays down the rule of taxation of income earned by the seconded employee by giving the right to tax by the state where employment is exercised. The term 'employment is exercised' means the place where the employee is physically present when performing the activities for which the employment income is paid.

[1] Toyota Boshoku Automotive India Pvt Ltd v. DCIT (IT(TP)A No. 1646/Bang/2017) – Taxsutra.com

Article 15(2) of the OECD Model Convention carves out an exception to the rule in Article 15(1) by facilitating short term secondment without the burden of having to pay tax in the country where the employment is exercised subject to the three conditions[2].

Since the right of the state of the temporary employment to tax employment income was limited by the provisions and conditions of Article 15, the tax administrations were not happy to notice that non-resident labor was easily entering their boundaries and easily avoiding source country taxation. As a possible contribution to solving problems of abuse, recent OECD guidelines lay down guidelines to resolve interpretation issues concerning the concept of 'employer' for purposes of Article 15(2). In determining the employer, the guidelines attach importance to the nature of the services rendered, in order to determine, whether the services rendered by the individual constitute an integral part of the business of the enterprise to which these services are provided.

In the cases where the nature of the services rendered point to an employment relationship different than the one of the formal employers, the guidelines suggest objective criteria to determine the employer, namely:

- who has the authority to instruct the individual regarding the manner in which the work has to be performed.
- who controls and has responsibility for the place at which the work has been performed
- the remuneration of the individual is directly charged by the formal employer to the enterprise to which the services are provided
- who puts the tools and materials necessary for the work at the individual's disposal.
- who determines the number and qualifications of the individuals performing the work.

As a consequence, instead of being regarded as non-resident employees of a non-resident employer rendering services on a temporary basis, individuals may, if certain objective criteria are met, be deemed to be the employees of the service recipient in the other country (i.e., source country), and therefore, taxable in the source country where they are performing their services.

On a perusal of the 'Agreement of employees on loan', between the taxpayer and Japanese entity, it indicates that the control and supervision of the seconded employee is with the taxpayer in India. The salary of expatriate employee will be paid by the Japanese entity, that sends the employee on deputation. Japanese entity continues to be the de jure employer. The taxpayer in India, to which the employee is sent on deputation is the de facto employer. The salary paid by the de jure employer was reimbursed by the taxpayer in India, to the Japanese entity.

The agreement imposes an obligation of compliance with tax deduction at source as per the Act, on salaries paid to the seconded employees on the taxpayer in India.

The process of secondment of employees by the Japanese entity to the taxpayer in India was initiated, when the taxpayer in India, makes a request requiring the services of seconded employees of the Japanese entity, for its business projects by the taxpayer in India. The taxpayer in India gives an offer letter to the seconded employees.

Admittedly, the taxpayer deducted tax at source under Section 192, on the 100 per cent salary paid to all the seconded employees and paid the same to the credit of the Central Government. The taxpayer only reimbursed part of the salary cost of the seconded employee to a Japanese entity that was already subjected to TDS under Section 192 of the Act. Therefore, at the time of making such reimbursement to Japanese entity, no taxes were deducted at source by the taxpayer in respect of reimbursements made as, according to the taxpayer, it was in the nature of cost-to-cost reimbursement, and no element of income was involved.

The taxpayer in India was the economic and de facto employer of the seconded employees. All the seconded employees were in India for more than 183 days in a 12-month period. Further, all the seconded employees have PAN card as well as file their returns in India in respect of the 100 per cent salary, though the taxpayer pays only part of the salary in India. Therefore, it was observed that there exists an employer-employee relation between the taxpayer and the seconded employees.

On perusal of Article 12(4) of India-Japan tax treaty (tax treaty), it was observed that the payments made to individuals or firm of individuals for services rendered by them in independent capacity are specifically excluded as they are covered by Article 14 being 'Independent Personal Services'. Article 12(4) also excludes payments made towards services rendered by an 'employee' of an enterprise. The definition of FTS under the Act excludes 'consideration which would be income of the recipient chargeable under the head salaries'. If the seconded employee is regarded as employee of the taxpayer in India, then the reimbursement to Japanese entity, by the taxpayer in India would not be in the nature of FTS, but would be in the nature of 'salary', and therefore, the reimbursements cannot be chargeable to tax in the hands of Japanese entity, and therefore there would be no obligation to deduct tax at source at the time of making payment under Section 195.

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[2] (a) If the recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in any 12 months commencing or ending in the fiscal year concerned. and;
(b) if the remuneration is paid by, or on behalf of, an employer who is not a resident of the other State; and
(c) if the remuneration is not borne by a permanent establishment or a fixed base which the employer has in the other State.

The Supreme Court in case of DIT v. Morgan Stanley[3] held that, in the case of deputation, the entity to whom the employees have been deputed cannot be regarded as employer of such employees as the employees continue to have lien on his employment with the entity which deputes him. However, the observations of the Supreme Court in the case of Morgan Stanley were in the context of existence of Service PE. In the present facts of the case there was no finding, of their existing PE, in any form by the tax department and therefore was of no assistance to the tax department.

The Tribunal observed that the liability under Section 195 to deduct tax at source when making payment to a non-resident arises only if sum paid is chargeable to tax in India. Payment of salaries was not covered under Section 195. Payment for supplying skilled manpower cannot be regarded as payment towards managerial, technical and consultancy services as per the dictionary meanings of these terms. The AAR in the case of Cholamandalam MS General Insurance Co. Ltd.[4] observed that, merely supplying technical, managerial or personnel with managerial skills cannot be regarded as rendering technical services by the person supplying such personnel.

The Tribunal observed that the decisions[5] relied by the tax department are distinguishable with the present facts of the case. Relying on various decisions[6], the Tribunal held that the reimbursement made by the taxpayer in India to Japanese entity, towards the seconded employees cannot be regarded as FTS and therefore not liable to deduct tax under 195.

Our comments

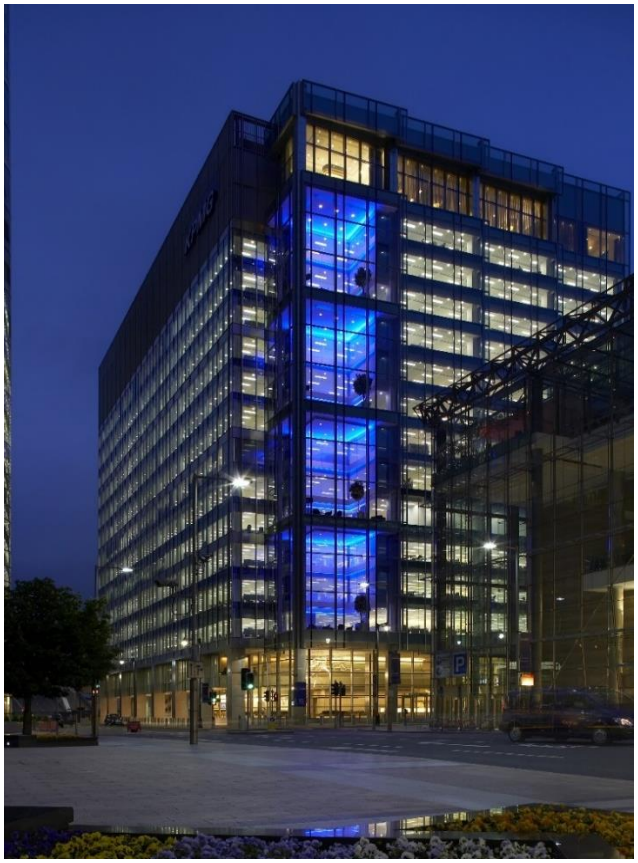
The issue with respect to whether tax needs to be deducted on reimbursement of salary cost under the secondment arrangement has been a matter of debate before the Courts.

Some of the Courts/Tribunal[7] have held that if the seconded employees are viewed in substance as employees of the Indian entity, the payments made to the foreign entity by the Indian entity may be characterised as a mere reimbursement, and accordingly, no further tax implications arise on the payment thereof.

However, in a few cases the Courts/Tribunal[8] have held that a payment made to a foreign company for the services of the deputed personnel under the secondment agreement is taxable as FTS. In the case of payment being FTS or royalty under Section 9(1), it is irrelevant whether any profit element is included in the income or not.

The Delhi Tribunal in the case of AT & T Communication Services (India) P. Ltd.[9] while distinguishing the decision of the Delhi High Court in the case of Centrica India Offshore (P.) Ltd. held that reimbursement made by the Indian company could not be classified as FTS/FIS under the Act as well as under the India-US tax treaty. It was observed that the seconded employees of a foreign company were not engaged in the business of the foreign company in India but were effectively working under the control and supervision of the Indian company.

The Tribunal in the present case has held that the reimbursement made by the taxpayer in India to a Group concern, towards the salary of seconded employees cannot be regarded as FTS and not liable to deduct tax under 195. There exists an employer-employee relation between the taxpayer and the seconded employees. The seconded employees were regarded as employees of the taxpayer in India, and therefore the reimbursement to the Japanese entity is not in the nature of FTS.



[3] DIT v. Morgan Stanley [2007] 162 Taxman 165 (SC)
[4] Cholamandalam MS General Insurance Co. Ltd. [2019] 309 ITR 356 (Mad)
[5] Centrica India Offshore Pvt. Ltd. v. CIT [2014] 364 ITR 336 (Delhi), Verizon Data Services India P Ltd. In re [2009] 337 ITR 192 (AAR), Food World Supermarkets Ltd v. DDIT [2015] 63 taxman.com 43 (Bang)
[6] DIT v. Abbey Business Services India (P.)Ltd. [2020] 122 taxmann.com 174 (Kar), Cholamandalam MS General insurance Co. Ltd [2009] 309 ITR 356 (AAR), DIT v. Marks and Spencers [2013] 138 taxmann.com190 (Bom), , DIT v. HCL Infosystems Ltd [2005] 144 taxman 492 (Mum), IDS Software Solutions India Pvt.Ltd. v. ITO [2009] 122 TTJ 410 (Bang), Faurecia Automotive Holding v. DCIT (ITA No,784/Pun/2015, dated 8 July 2019) (Pune)
[7] Abbey Business Services (India) (P) Ltd v. DCIT [2012] 53 SOT 401 (Bang), DDIT v. Tekmark Global Solutions LLC [2010] 38 SOT 7 (Mum), Morgan Stanley Asia (Singapore) Pte. Ltd. v. DDIT [2018] 95 taxmann.com 165 (Mum), Temasek Holdings Advisors (I) (P.) Ltd. v. DCIT [2013] 38 taxmann.com 80 (Mum)
[8] Centrica India Offshore (P.) Ltd. v. CIT [2014] 44 taxmann.com 300 (Del), Food World Supermarkets Ltd. v. DDIT [2015] 174 TTJ 859 (Bang)
[9] AT & T Communication Services (India) P. Ltd. v. DCIT (ITA No.354/Del/2017)

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