CNK & ASSOCIATES LLP
CHARTERED ACCOUNTANTS

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## International Tax-Judicial Decisions

### *Interest income earned in India, not connected with the Indian permanent establishment would get taxed at 10% as per Article 11(6) of the India Japan Tax Treaty and not at 40% as per Article 7(1)*

***Marubeni Corporation, Japan [TS-485-ITAT-2022(Mum)]***
***(in favor of assessee)***

**Facts:**

The Assessee was a company incorporated in and tax resident of Japan. The Assessee had earned income from its permanent establishment (PE) in India of Rs 8,47,64,383, technical services fees of Rs 31,76,15,635, income from shipping business of Rs 1,09,53,179 and interest on suppliers' credit of Rs 2,25,89,136.

The interest on suppliers' credit was received from its customer on sale of certain products manufactured by another entity located in Japan. The Assessee offered the interest income to tax at the rate of 10% as per Article 11(2) of India-Japan Tax Treaty, on the ground that the same was not attributable to the Assessee's PE in India. The AO held that since the assessee had a PE in India the exclusion clause of Article 11(6) was triggered. Article 11(6) states that if interest income is attributable to PE in India concessional rate prescribed under Article 11(2) would not apply and taxed the said interest income at 40%.

**Held:**

If an enterprise of Japan carries on business in India, the profits of such an enterprise may be taxed in India, but only to the extent, such profit is directly or indirectly attributable to that PE in India.

It was observed by the Tribunal that mere existence of a PE in the source jurisdiction cannot, be a reason enough to invoke the taxability of an interest income under Article 7(1) as business income unless such an income is directly or indirectly attributable to such a PE. In fact, even if a person has a fixed base for providing independent personal services, and an interest income can be said to be connected with the same, it cannot be brought to tax under Article 14(1) on independent personal services unless such an interest income is attributable to that fixed base.

Merely the fact that interest income received by the assessee are from the same clients in India with whom contracts were executed through the PE in India and assessee had received fees for technical services, is irrelevant as long as interest income is not demonstrated to be attributable to the PE. Such attribution cannot be inferred or assumed.

Accordingly, it was held that since there is no cogent material to establish the fact that the interest income was directly or indirectly attributable to activities carried on by the PE, interest income would get tax at 10% as per Article 11(2) and not at 40% as provided under Article 7 or 14 of India Japan DTAA.

***Amount paid by Indian Company to US Company towards payment of salary of Seconded Employees does not fall within the ambit of Fees for Technical Services and thereby withholding of tax is not application.***

***Flipkart Internet Private Limited [TS-503-HC-2022(KAR)]***
***(in favor of assessee)***

**Facts:**

The Assessee is an Indian company ( 'I Co') engaged in the business of providing Information Technology Solutions and Support Services for e-commerce industry and is an affiliate of a company based in Singapore ('S Co').

S Co entered into a Master Service Agreement ('MSA') with another company based in USA ('USCo'). As per the MSA either of the parties to the Agreement or its affiliates could use seconded employees.

In terms of the MSA, the USCo had seconded 4 employees to I Co and had entered into a Global Assignment Arrangement with the seconded employees which provided that these seconded employees would work for the benefit of I Co.

- I Co had issued letter of appointment confirming the employment of seconded employees.
- in the letter of appointment, the details of responsibilities of the seconded employees were mentioned.
- I Co made PF contribution as an employer of seconded employees.
- The seconded employees were working in India on 'Employment VISA' wherein I Co was declared to be an 'employer'.
- I Co was granted unconditional rights to terminate the employment of seconded employee.
- I Co had withheld tax u/s 192 of the Act on the salary amount of the seconded employees.

I Co filed an application before the Indian tax authorities under the provisions of Section 195(2) of the Act requesting to remit, salary of seconded employees on cost-to-cost reimbursement basis without withholding any tax in India.

The AO rejected the application on following grounds:

a. There was no employer-employee relationship between the I Co and the seconded employees. The purpose of payment shows that the same falls within the ambit of Fees for Technical Services (FTS) in terms of Section 9 as well as in terms of DTAA between India and USA.
b. Mere deduction of tax at source under Section 192 does not obviate the need to deduct tax at source under Section 195, as tax at source is to be deducted on the gross payment and the question of examining the income element embedded therein does not arise.
c. The examination of documents reveals that the seconded employees remain the employees of USCO even during the period of secondment.
d. As the MSA is entered between two related parties, even if consideration is agreed on cost-to-cost basis, the character of payment would not change.

Against the rejection order, I Co filed a writ petition before Karnataka High Court.

**Held:**

The High court allowed the Writ petition filed by I Co by making following observations-

- <u>The provisions of Act would apply to the extent they are more beneficial</u>

  Section 90(2) of the Act provides that for the purpose of granting relief of tax or for avoidance of double taxation provisions of the Act would apply to the extent they are more beneficial to the taxpayer. The High court also referred to the decision of the SC in case of Engineering Analysis Centre of Excellence Private Limited v CIT & Another (432 ITR 471), wherein it was held that if the provisions of the "DTAA" are more beneficial than the provision of Act, it is the "DTAA" that should be treated as the law that requires to be followed and applied.

  The amount paid to USCO does not result in making available of any services so as to be treated as FTS under Article 12 of India USA DTAA.

  To fall within the ambit of FTS as contemplated in Article 12(4)(b), it is necessary that the rendering of technical or consultancy services must make available technical knowledge, experience, skill, know how or processes to ICO.

  The High Court opined that the AO rejected the application without examining the aspect of make available. The fact that seconded employees have "requisite experience, skill or training capable of completing the services contemplated in MSA by itself is insufficient to treat it as 'FTS.

- <u>Deduction of tax u/s 195 is not on Gross Receipts</u>

  The logic of deduction of tax on the gross amount is relevant in the context of Section 194C and Section 194J and cannot be extended to Section 195 which specifically uses the term "any other sum chargeable under the provisions of the Act". The High Court relied on the decision in case of **GE India Technology Centre (P) Ltd v. Commissioner of Income Tax and Another [(2010) 10 SSC 29]** wherein it is held that the obligation to deduct tax at source arises only on the sum which is chargeable under the Act and accordingly rejected the argument of the AO that the gross receipt is liable for withholding of tax.

- <u>Employer -Employee Relationship</u>

  The court examined the terms of MSA and observed that-

  - USCo has the power to decide on the employees' continuance with USCo after the period of secondment or its termination. The said power would not make any difference, as it would relate to a service condition post the period of secondment.
  - The equity eligibility of the seconded employee which was a pre-existing benefit prior to secondment ought not to alter the relationship of employer and employee between the I Co and the seconded employees.
  - USCo making the payment to seconded employees would not alter the relationship between the I Co and seconded employees as I Co only seeks to make payment to USCo of its payment to seconded employee which is by way of reimbursement.
  - I Co was not acting as a back office for providing support service to the USCo so that the USCO could be treated as an employer
  - I Co had issued the appointment letter, seconded employee reports to I Co, and it is I CO who has the power to terminate the services of the employee

- <u>Decision of Delhi High Court in case of Centrica India distinguished on facts</u>

  The Delhi High Court in the case of Centrica India had treated overseas entities as real employer of the deputed employees.

  Accordingly, payment made by Centrica India to overseas entities for services rendered by deputed employees was held as taxable as FTS as per the India Canada Tax Treaty.

The court distinguished the facts of Centrica India from the facts of the present decision, by stating that-

- Though the control and supervision rested with Centrica India, it was the overseas entity who bore all risks in relation to their work. There was no purported relationship between Centrica India and the deputed employees.
- The employees were entitled to participate in the overseas retirement and social security plans and other benefits. There was no obligation clearly spelt out that Centrica India must bear the salary cost of the deputed employees.
- No powers were vested with Centrica India to terminate the ultimate contract between the overseas entities and the deputed employees.
- Whilst Centrica India may have had operational control over these persons in terms of their daily work and may have been responsible for their failures (in terms of the agreement), these limited and sparse factors could not displace the larger and established context of employment abroad.

Based on above findings the High Court directed the AO to issue Nil withholding tax certificate to I Co.

**CNK Comments:**

The Supreme Court (SC) in the case of CCCEST vs. Northern Operating System ('NOS')(138 taxmann.com 359) had examined the issue of seconded employees from overseas company to the Indian company from service tax perspective. The SC had held that Overseas Co. had a pool of highly skilled employees and having regard to their expertise were seconded to the Indian entity. Upon cessation of the term of secondment they would return to their overseas employer. Based on these facts it was held that the Indian entity was liable to service tax.

The High Court held that the decision of SC was rendered in the context of erstwhile service tax law to determine whether supply of manpower was covered under taxable service. On the other hand, under the Income Tax Act, one needs to determine whether the services fall within the ambit of FIS i.e., make available clause is triggered so as to be chargeable to tax. Accordingly, the High Court held that the findings of the SC decision on taxability under service tax would have no impact on its taxability under the income tax act.

One needs to bear in mind that even though the High Court has distinguished the SC decision, the tax authorities could use this decision rendered under the erstwhile service tax law to contest that the amount reimbursed to overseas entities for services rendered by seconded employees being liable to service tax would also fall within the ambit of FTS and thereby liable to withholding tax in India.

## *Mauritius Revenue Authority clarifies that income distributed by foreign fiscally transparent entities to tax residents of Mauritius will retain its initial character in Mauritius*

**Facts:**

L, a resident of Mauritius, pools funds from various investors across the globe (excluding Indian residents) and invests in India through Alternative Investment Funds ('AIF') Category II and Category III. The Investment Manager of L is N which is a company incorporated under the Companies Act (Cap 50) in Singapore and regulated by the Monetary Authority of Singapore.

L raised the following issues before the Mauritius Revenue Authority (MRA) with regards to taxability in Mauritius of the Income received by L on investment made in the Indian AIFs-

- Whether dividend income, interest income and capital gains accrued by the AIF Trust and distributed to L will be considered as dividend income, interest income and capital gains respectively in the hands of L for

for income tax purposes in Mauritius.

**Held:**

All distribution (including interest and capital gains) made by the AIF Category II & III to L will be treated as dividend income in Mauritius i.e., the income would not retain its initial characteristics in India.

**CNK Comments:**

This ruling of the MRA created a ripple across Mauritius investment funds investing in Indian AIFs. This is because under Mauritius income tax law, income in the nature of dividend and interest is taxable, but capital gains are exempt from tax. Hence, conversion of initial character of 'capital gains' income distributed by a fiscally transparent AIF in India, to that of 'dividend' in Mauritius, would result in a tax liability for the Mauritius investment fund.

In light of this issue, on 1 July 2022, the MRA clarified that income distributed by foreign fiscally transparent entities to Mauritius tax residents would retain its initial character in Mauritius. Hence, any capital gains distributed by a foreign fiscally transparent entity to a Mauritian tax resident shall be treated as capital gains in Mauritius. Resultantly, such capital gains would not be subject to tax in Mauritius under the Mauritius tax law.

This is a welcome amendment and will provide relief to Mauritius investment funds investing in Category I and II AIFs in India, which are fiscally transparent in India. It however does not address the issue of income distributed by Category III AIFs to such funds (as Category III AIFs are not fiscally transparent in India). Whether this is a conscious position of the MRA or is an inadvertent oversight is still not clear.

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