Tax Hotline

December 10, 2013

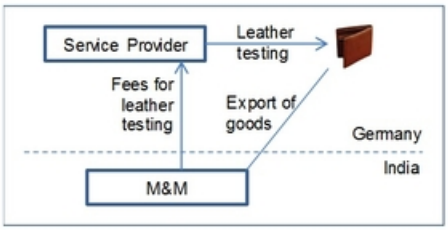
RETROACTIVE WITHHOLDING REQUIREMENT CANNOT BE BASIS FOR EXPENSE DISALLOWANCE

- Leather testing services are technical services if they involve human intervention.
- Technical service fees paid even by a 100% export oriented unit would be India sourced.
- For technical services, nexus is determined by the situs of the taxpayer and where services are utilized and not by where services are rendered.
- Payment for services are deductible from gross income even though tax was not withheld based on a retroactive tax amendment.

The Income Tax Appellate Tribunal ("**Tribunal**") at Agra recently held in the case of *Metro and Metro*[1] that expenditure incurred for leather testing services by Metro & Metro ("**M&M**"), a 100% Export Oriented Unit ("**EOU**") to a German certifying entity ("**Service Provider**") is taxable as Fees for Technical Services ("**FTS**") if human intervention is involved in the provision of such services. However, it was held that the expenditure incurred would be deductible from gross income even if tax was not withheld based on a retroactive amendment since an assessee cannot be expected to withhold tax as per law that is introduced subsequent to payment ("**Ruling**").

BACKGROUND

M&M is a manufacturer and exporter of leather goods and is a 100% export-oriented unit ("**EOU**"). In the financial year 2007-08, it paid INR 52 lakhs (about USD 0.1 million) for leather testing to be performed by the Service Provider in relation to goods exported by M&M to Germany. These services were rendered outside India and were necessary to ensure compliance with applicable safety standards for sale in Germany.



The dispute in issue: The Assessing Officer ("**AO**") refused to allow deduction for expenditure incurred by M&M for leather testing on the ground that it did not discharge withholding obligations under the Income Tax Act, 1961 ("**ITA**") on such payment. Under the ITA, there is a restriction on deduction for taxable payments to non-residents where tax has not been withheld. The AO contended that the consideration paid for leather testing constituted 'fees for technical services' ("**FTS**") both under the ITA and the India-Germany tax treaty ("**Treaty**") and was therefore, taxable in the hands of the Service Provider and subject to withholding by M&M. This was confirmed by the Commissioner of Income Tax (Appeals) ("**CIT(A)**") on appeal. Aggrieved by this finding, M&M approached the Tribunal

Legal context: In the 2007 decision of *Ishikawajima-Harima*[2], the Hon'ble Supreme Court of India held that services rendered outside India by a non-resident could not be taxed in India owing to lack of sufficient territorial nexus with India. However, later, in 2010, an amendment was introduced with retroactive effect from 1976 ("**Amendment**"), stating that FTS paid by a resident to a non-resident would be deemed to accrue or arise in India irrespective of whether the non-resident rendered services in India as long as such services are not utilized by a resident outside India in its overseas business or for the purpose of earning foreign income.

TRIBUNAL'S RULING

Proud Moments

Legal500 Asia-Pacific: Tier 1 for Tax, Investment Funds, Labour & Employment and TMT
2020, 2019, 2018, 2017, 2016, 2015, 2014, 2013, 2012

Chambers and Partners Asia Pacific: Band 1 for Employment, Lifesciences, Tax and TMT
2020, 2019, 2018, 2017, 2016, 2015

IFLR1000: Tier 1 for Private Equity and Project Development: Telecommunications Networks.
2020, 2019, 2018, 2017, 2014

AsiaLaw Asia-Pacific Guide 2020: Tier 1 (Outstanding) for TMT, Labour & Employment, Private Equity, Regulatory and Tax

FT Innovative Lawyers Asia Pacific 2019 Awards: NDA ranked 2nd in the Most Innovative Law Firm category (Asia-Pacific Headquartered)

RSG-Financial Times: India's Most Innovative Law Firm
2019, 2017, 2016, 2015, 2014

Benchmark Litigation Asia-Pacific: Tier 1 for Government & Regulatory and Tax
2019, 2018

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The primary issue was whether the fee paid for leather testing services may be deducted for computing M&M's taxable income even though tax was not withheld based on the retroactive tax amendment. This required a preliminary assessment of whether the fees were taxable and whether M&M was required to withhold taxes on such fees.

Taxation of fees for technical service: Following decisions in *Bharti Cellular Limited*[3] and *Right Florists*[4] (which dealt with payments made to Google by Indian advertisers), the Tribunal held that when no human intervention is involved in provision of services, the payment made for the same cannot constitute FTS under the ITA. However, the Tribunal held that the question to be determined was whether there was any presence of human involvement at all, irrespective of whether it was of routine nature or pertained to the core analysis. As human intervention was involved with respect to non-core activities like preparation of reports, the Tribunal concluded that the leather testing was a technical service.

Application of FTS to 100% Export Oriented Units: Non-resident service providers are not taxable if services are utilized: (a) in a business carried on outside India or (b) for earning income from sources outside India. The Tribunal held that even if M&M exported all its goods to foreign customers, it carried on business in India and therefore, did not satisfy either of the two exclusions. Hence, the fee paid to the German Service Provider was considered to be sourced in India.

Nexus of income with India: The Supreme Court in *Ishikawajima-Harima* held that the services rendered by a non-resident outside India did not have a territorial nexus with India. The Tribunal endorsed the decision in *Ashapura Minichem*[5], which held that *Ishikawajima-Harima* was not applicable post the Amendment. The Tribunal held that nexus with a tax jurisdiction is determined by the situs of the taxpayer and the situs of utilization of services, irrespective of the situs of provision of services.

Deductibility of service fees: Under the ITA, a payment to a non-resident cannot be claimed as deduction from gross income if tax was not withheld as prescribed. The Tribunal had to consider whether this rule applied even if failure to withhold tax is owing to a retroactive amendment. Prior to the Amendment, as per the decision in *Ishikawajima-Harima*, services rendered by non-residents outside India were not taxable in India under the ITA. Considering certain earlier decisions[6], it was observed that the law cannot cast a burden of performing an impossible obligation of withholding tax with retroactive effect. As the failure to withhold tax was due to a retroactive amendment, the Tribunal held that M&M could not be expected to withhold tax as per law introduced subsequent to the payment and thus, that the service fee was deductible expenditure for M&M.

ANALYSIS - REVISITING VODAFONE

Although the Ruling was delivered in the context of deductibility of expenses, it highlights a general principle that a person cannot be adversely impacted for failing to withhold taxes due to liability arising out of a retroactive amendment. Till the Amendment was introduced in 2010, based on the decision in *Ishikawajima*, the law was clear - if services were provided by a non-resident outside India, there was no taxability and therefore, no withholding tax obligation. Subsequently, the 2010 retroactive amendment was introduced, according to which FTS was made taxable in India irrespective of situs of rendition. The Tribunal explains the sheer impossibility and unreasonableness in requiring a person to withhold tax for payments made in the past.

One is urged to think of this principle in light of the *Vodafone* saga, where there was an offshore transfer of a foreign company's shares and the tax department sought to treat the buyer liable for not withholding tax on such transfer. The Supreme Court held that the buyer was not liable to withhold tax as the transaction was not taxable in India.[7] Afterwards, retroactive amendments were introduced in 2012 making offshore share transfers taxable in India if the shares substantially derived their value from assets located in India.[8] The question that arises is how one can be retrospectively made liable to withhold taxes. Such unreasonable laws enacted with retroactive effect destroy certainty and dampen investor sentiments.

The Ruling also makes an important observation on the taxation of technical services - human intervention is an important element required to classify services as technical services. However, it disagrees with the decision in *Siemens Ltd*[9], which held that services provided with minimal human intervention inevitably involved for services provided using technology or any machine (for eg., monitoring the process, preparing the report, issuing certificates, etc., as compared to constant human endeavor), are not technical services. Thus, the extent to which such the Tribunal's observation on human intervention may be relevant is very restricted.

However, unlike the Indo-German Treaty, some other treaties (like the treaties with the US, the UK, Canada, Singapore, etc.) prescribe an additional 'make available' condition for a service to qualify as FTS, i.e., the services should enable the recipient of the service to apply the underlying technology in similar circumstances. For example, in case of leather testing, the question whether the recipient of the services would be able to conduct leather testing on similar goods on its own would determine whether technical knowledge has been 'made available'. Thus, since the Indo-German Treaty is different in that respect, the Ruling would become applicable only to similarly worded treaties.

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– T.P. Janani & M.S. Ananth
You can direct your queries or comments to the authors

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[1] *Metro and Metro v. ACIT* (ITA No. 393/Agra/2012, dated November 1, 2013).

[2] *Ishikawajma-Harima Heavy Industries Ltd v. DIT*, [2007] 288 ITR 408 (SC).

[3] *CIT v. Bharti Cellular Ltd*., (2009) 319 ITR 139 (Delhi), endorsed by the Supreme court in appeal on the limited question in issue.

[4] *ITO v. Right Florists Pvt Ltd*., (2013) 25 ITR(T) 639 (Kolkata - Trib.); Our earlier hotline on the *Right Florists* case can be accessed here.

[5] *Ashapura Minichem Ltd. v. ADIT* (ITA No. 2508/ Mum/ 2008).

[6] *Channel Guide India Ltd v. ACIT* (139 ITD 49); *Sterling Abrasives Ltd v. ITO* (ITA No. 2234 and 2244/ Ahd/ 2008).

[7] Our earlier hotline on the *Vodafone* judgment can be accessed here.

[8] Our earlier hotline on the retroactive amendments can be accessed here.

[9] *Siemens Ltd v. CIT* (ITA No. 4356/Mum/2010).
