Supervisory fees paid for installation of equipment are taxable as FTS and not as business profits since such fees are not effectively connected with a Permanent Establishment in India

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Background

Recently, the Delhi Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Sumitomo Corporation[1] (the taxpayer) held that supervisory fees for installation of equipment are in the nature of Fees for Technical Services (FTS) and it was not effectively connected with taxpayer's Permanent Establishment (PE) in India. Therefore, the fees are taxable at the rate of 20 per cent[2] under India-Japan tax treaty (tax treaty) and not taxable as business profits.

Further, the Tribunal held that taxpayer's Liaison Office (LO) in India was merely acting as a communication channel and was not involved in supervisory activities. Therefore, existence of LO cannot be the basis to be held as supervisory PE in India. Further, test of minimum period of 180 days for supervisory PE contemplated in Article 5(4) of the tax treaty should be determined for each individual site/installation project.

Facts of the case

- The taxpayer, a Japanese company, had established LO in India with the approval of the Reserve Bank of India (RBI) for facilitating imports from Japan and exports from India. The LO acted as a communication channel between Indian importers and the taxpayer, who sold its goods and commodities on a principal-to-principal basis to such Indian importers. Subsequently, the taxpayer expanded its activities in India and established three Project Offices (POs) for Maruti Udyog Ltd. (MUL).

- The Head Office (HO) of the taxpayer had secured various contracts for supply of equipments. Under some contracts, supply of equipments was to be made by the taxpayer and it was also responsible to supervise the installation of the equipments. While in some of the contracts, it was the responsibility of MUL to carry out the actual installation and the taxpayer was only to supervise the installation.

[1] Sumitomo Corporation v. DCIT (ITA No. 5882,5883/Del/1998) – Taxsutra.com
[2] FTS are taxable at 20 per cent under Article 12 of India-Japan tax treaty

- During the years[3] under consideration, the taxpayer received supervision fees for supervising the installation of the machinery and equipment supplied from Japan.

- The Assessing Officer (AO) held that LO and POs of the taxpayer were in the nature of PE and therefore, the supervision fees received was treated as effectively connected with PE , taxable under Section 115A of the Income-tax Act, 1961 (the Act). The AO also held that the supervision fees could not be brought to tax at the rate of 20 per cent under Article 12(2) of the India-Japan tax treaty.

- The Commissioner of Income-tax (Appeals) [CIT(A)] upheld the order of the AO. However, the Tribunal held that supervision fees received by the taxpayer were taxable as FTS at the rate of 20 per cent under Article 12(2) of the tax treaty.

- When issue reaches to the Delhi High Court (High Court), it remanded back the issue again to the Tribunal on the question of whether the supervision fees received by the taxpayer was taxable as FTS under Article 12(2) or business profits under Article 7 of the tax treaty.

Tribunal's ruling

- There was no scope for any intervention regarding the character of the income as the High Court has already held that supervision fees were in the nature of FTS. With regard to the taxability of FTS in taxpayer's case for having a PE, there are variations in accordance with the OECD/UN/US Model Conventions.

- Article 12(5) of tax treaty is on the line of OECD Model Convention wherein it provides that PE is liable to tax those profits which are economically attributable to it and the income should arise as a result of the activities of the PE. The state where the PE is located can tax the income only, if a connection exists, between the income and the PE. Thus, Article 12(5) of the tax treaty does not have force of attraction principle.

- In the present case the taxpayer had a PE in respect of the two projects but the income earned in respect of supervisory services is not attributable to any of these PE. In order to apply Article 12(5) of India-Japan tax treaty, the beneficial owner of the FTS should carry on business in India in which the FTS arises through a PE and the contract in respect of which FTS is paid, should be effectively connected with such PE. When these two conditions are satisfied, provisions of Article 7 of the tax treaty will apply.

- The term 'effectively connected' used in Article 12(5) of tax treaty is not to be construed as the opposite of 'legally connected' but in the sense of something 'really connected'. The connection must be real in substance and producing activities should be closely connected in terms of relationship besides being connected economically also with the PE.

- LO was only facilitating the communication of the HO with MUL and was nowhere involved in the supervisory activities. Simply existence of the LO cannot be a basis that taxpayer was having supervisory PE in India. There was no evidence whether the LO has violated the conditions laid down by RBI in this regard.

- The supply of indigenous equipments, installation and commissioning of equipments at MUL by the taxpayer was carried out by the PO of the taxpayer and the income arising out of such activity was offered to tax on net income basis which was not disputed.

- In respect of the supervision PE, it has also been observed that the purchase orders were procured by the taxpayer through its HO pursuant to competitive bidding on global tender floated by MUL and the terms and conditions of each purchase orders were different and it was not linked with the other purchase orders.

- The performance guarantee given by the taxpayer was also different for different work. The work of installation and supervision were done independently. The nature of the equipments supplied by the taxpayer was used in different stages of production and at different sections of car manufacturing process.

- Even equipments supplied under one purchase order were not complemented to the equipment supplied in another purchase order. The installation of equipments was to be carried out by MUL. The technicians were deputed for supervisions of work from Japan. Separate tenders were floated for each of the purchase orders and the taxpayer was not the only bidder and there were other enterprises which were awarded purchase orders also.

- The Tribunal observed that the period of supervision under each contract was less than the period of 180 days as contemplated under Article 5(4) of the tax treaty. It was also held that where there are several sites where supervision is going on in a country, the rule is that the test of minimum period should be determined for each individual site or installation project.

[3] AY 1992-93 to 1996-97

- The taxpayer rendered supervision to the plant and machinery supplied by it from Japan. To supervise installation cannot be termed as having a PE in India when the same is not effectively connected with any PE in India. The rate of tax at which the tax has been deducted cannot be a determining factor for nature and character of the income. There was no dispute remains about the payment received by the taxpayer, the same is FTS.

- The personnel of LO present in the meetings with MUL were only accompanying the persons deputed from Japan and they were not having any role in the meeting. Accordingly, it has been held that the income is taxable as FTS under Article 12(2) of the tax treaty for AY 1992-93, 1993-94, 1994-95 and 1996-97. However, for AY 1995-96, the question of taxability of FTS was remanded back to the AO.

Our comments

This is a welcome ruling of the Delhi Tribunal where it has been held that the supervisory fees for installation of equipment was not effectively connected with taxpayer's PE in India. Therefore, it is taxable as FTS on gross basis at the rate of 20 percent and not as business income under the tax treaty.

It is pertinent to note the decision of the Special Bench of the Delhi Tribunal in the case of Clough Engineering Ltd.[4] where it has been held that interest income earned on income-tax refund was not effectively connected with the PE of the taxpayer. Therefore, such interest was taxable at a concessional rate of 15 percent under India-Australia tax treaty.

[4] ACIT v. Clough Engineering Ltd [2011] 11 taxmann.com 70 (Del)

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