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# Article

## Taxation of independent personal Service - Can legal form of entity alter right to tax income?

By **Karanjot Singh Khurana**

### *Introduction*

Under OECD Model Tax Convention (**'MTC'**), income from professional services was taxed in terms of Article 14 titled 'Independent Personal Services' (**'IPS'**). However, Article 14 was deleted from the OECD MTC with effect from 29th April 2000 and the taxation of income from professional services was brought at par with taxation of business profits as provided in Article 7 of OECD MTC[1]. Even after its deletion from OECD MTC, Article 14 continues to find place in UN MTC and the tax treaties entered by India.

It has always been a dispute internationally as to whether Article 14 applies only to natural persons (individuals) or even to artificial persons (like partnership firms, companies, etc.). Countries have adopted different positions on this issue. While Mexico and Turkey share the view that Article 14 should apply to artificial persons as well, it was explained in commentary to US MTC that the scope of Article 14 (as it existed before its deletion from US MTC) is restricted to individuals alone.

In order to better appreciate the scope of Article 14, it is necessary to first discuss the scope of professional/technical services.

### *Taxation of income of non-resident from professional services*

Under Income-tax Act, 1961 ('**IT Act**'), the consideration received by a non-resident in the form of 'fee for technical services' ('**FTS**') is taxable in India. As per the IT Act, the term FTS has been defined to mean consideration for rendering any managerial, technical or consultancy service[2]. As observed by Supreme Court[3], the definition of FTS is wide enough to encompass the professional income within its ambit. Therefore, as per the IT Act, the income earned by a non-resident from provision of professional services in India should be exigible to tax in India.

In most of the tax treaties entered by India, there is an article relating to taxation of FTS wherein the source state is given a right to tax income from FTS. Moreover, IPS is excluded from the scope of FTS in these treaties to avoid overlapping between taxation of IPS and FTS.

Therefore, if one were to conclude that Article 14 is not applicable to an artificial person, the professional income of such person will fall within the scope of 'FTS' and the same would be taxable in the source country. Let us now examine the provisions relating to IPS in the treaties entered into by India.

### *Provisions of IPS in treaties entered by India*

As per the tax treaties entered by India, the source state gets the right to tax professional income only if such income is earned through a fixed base or in some cases, if the period of stay of service provider exceeds 183 days. While

[1] Report of working group titled 'Issues Related to Article 14 of the OECD Model Tax Convention'

[2] Explanation 2 to section 9(1)(vii) of IT Act

[3] *Continental Construction Ltd*. vs. *CIT*: [1992] 195 ITR 81 (SC)

there is consistency in these criteria, there is a contrast in terms of person covered by the article. Certain treaties (for example Article 15 of India-Denmark DTAA) specifically provide that the provisions relating to IPS are applicable to an individual and there are other treaties (for example Article 14 of India-UK DTAA) wherein the provisions have been extended to Individual and partnerships. Therefore, in these cases, wherein the scope of provisions has been specifically curtailed by the contracting parties to certain categories of tax payers, there is no room for ambiguity.

However, in many treaties entered by India the provisions relating to IPS applies to 'resident' of a contracting state. The question is whether the term "resident" can cover both natural as well as artificial persons.

### *Commentaries on the scope of IPS*

While the commentary on Article 14 in OECD MTC did not directly deal with the scope of provisions relating to IPS, the Commentary on Article 14 in UN MTC provided that the payment made to artificial person was not covered within Article 14[4]. However, the commentary also states that the contracting parties are open to provide any further clarification in this regard.

Further, as noted by the working group of OECD[5], the understanding stated in UN MTC can be attributed to the 183 day rule in the UN MTC which was not present in OECD MTC. Thus, if one were to rely on this understanding alone, it can be interpreted that in treaties where India has agreed to the 183 days rule, the reference to resident of contracting state, should be understood to apply only to individuals. But the number of days rule test is also present in Article 5 (relating to permanent establishment) of tax treaties and applies to both natural and artificial person. Thus, if the interpretation of working group of OECD is accepted for Article 14, such interpretation should also apply to Article 5, which will vitiate the already settled and followed practise of application of Article 5 to natural and artificial persons. Therefore, the comments in commentary to UN MTC and working group of OECD do not seem to clear the ambiguity surrounding the issue.

It is pertinent to mention that the working group of OECD did conclude[6] that there is no justification for imposing different rules to services depending on whether they were provided by a company or an individual.

Significantly, Prof. Klaus Vogel[7] has cited OECD and UN MC to opine that companies and other artificial persons are also capable of deriving income from professional services and should be covered within the Article 14. On the other hand, Philip Baker[8] has cited the judgment of German Bundesfinanzhof[9] to the effect that companies cannot perform personal services.

Therefore, different authors and Courts have expressed a divergent view on this issue. Though a part of the conflict can be attributed to the difference in how the Article 14 in worded in OECD and UN MTC, a major part of conflict seems to be pure difference in interpretation.

### *Judicial Precedents in India*

The issue regarding scope of Article 14 has been subject to judicial scrutiny in India. The

[4] Para 9 of Commentary on Article 14 of UN MTC
[5] Para 15 of Report of working group titled 'Issues Related to Article 14 of the OECD Model Tax Convention'

[6] Para 17 of Report of working group titled 'Issues Related to Article 14 of the OECD Model Tax Convention'
[7] In Para 13 of commentary on Article 14 in 3rd Edition 'Klaus Vogel on Double Conventions'
[8] Para 14B.05 of 'A Manual on the OECD Model Tax Convention on Income and on Capital'
[9] July 7, 1971, I.R. 41/70 (1971) BSt B1, II, 771

ITAT[10], had held that the use of the word 'his' in the article implies that the provisions relating to IPS are applicable to an individual alone.

It is apposite to mention that in the aforesaid case, the Bench was interpreting the erstwhile India-Denmark DTAA and the Para 1 of Article XIV (relating IPS) of then India-Denmark DTAA which specifically provided that the provisions of DTAA are applicable to an 'individual'. Therefore, it can be argued that the aforesaid interpretation cannot be supplied to a case where the contracting parties have agreed to extend the scope of the article to the 'resident of a contracting state'.

Further, it may also be appreciated that Para 1 Article 4 of DTAA refer a resident as 'his'. If the interpretation of Mumbai Bench of ITAT is accepted, then an artificial person may never be covered in the DTAA, which is clearly not the intention of contracting parties considering the fact that the para 3 of Article 4 clearly refers to persons other than individuals. Therefore, the use of the word 'his' in Article 14 need not be seen as an intent of the contracting parties to restrict the scope of article to individuals.

It is also worth discussing the findings of Hon'ble High Court of Delhi[11] wherein the Court while interpreting the provisions of section 194J of the IT Act held that the provisions of section 194J of the IT Act mandate that tax has to be deducted at source on payment of income in the nature 'professional services' to a person. The Court emphasised on the fact that the 'person' is wide enough to cover an artificial person and that the professional services cannot be restricted an individual providing such services in the course of carrying his profession. The aforesaid understanding was also upheld by Bombay High Court[12]. The provisions of section 194J of the IT Act are *pari-materia* with Article 15 of India-Spain DTAA, in as much as, in both cases, the underlying services are professional services and taxpayers covered are artificial as well as natural persons. Therefore, the judicial authorities in India seem to accept the fact that the professional services can be provided by artificial person as well.

## Conclusion

Internationally, it is very common for professionals to incorporate themselves into an entity, rather than practicing as individuals. In many cases, the incorporated professional entities provide consultancy, registration, certification and similar services to Indian residents. Owing to divergent views on the scope of Article 14, both domestically and internationally, it is likely that these entities may end up facing litigation wherein the tax authorities will contest that the income earned by such entity is taxable as FTS and the tax payer may want to claim benefit of Article relating to IPS. Therefore, it is important that the tax implications on these transactions are planned in advance to avoid subsequent litigation and surprises.

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[10] Hon'ble Mumbai Bench in case of in the case of *Christiani & Nielsen Copenhagen*: [1991] 39 ITD 355 (Mumbai)
[11] Vipul Medicorp TPA (P.) Ltd.: [2011] 245 CTR 125 (Delhi)

[12] *Dedicated Health Care Services TPA (India) (P.) Ltd*: [2010] 324 ITR 345 (Bombay)

# Circular

## Easing of requirement to obtain Pan Card by companies

The CBDT has clarified in press release dated 14-4-2018 that in case of corporate asessees, the PAN and TAN mentioned in the Certificate of Incorporation is sufficient proof of PAN and TAN of the said company. It notes that in view of the amended Section 139A (by Finance Act, 2018), the issue of laminated PAN card is no longer required. Companies may apply to the Ministry of Corporate Affairs though a Common Application Form for incorporation, and allotment of PAN, TAN and Tax Collection Number and the Certificate of Incorporation issued by the Ministry would mention both PAN and TAN. As part of improving Ease of Doing Business, CBDT had earlier tied up with the Ministry of Corporate Affairs to ensure that PAN and TAN were issued within one day of receiving the data on incorporation.

# Ratio Decidendi

## Payment to advertising agency for securing more business taxable as 'Commission'

The Supreme Court has upheld liability to deduct TDS on payment by an assessee running TV channels to advertising agency for purpose of securing more business, being 'commission' as contemplated under Section 194H of Income Tax Act, 1961. The assessee with a view to have a better regulation of the practice of advertising and to secure the best advertising services for the advertisers entered into an agreement with several advertising agencies. Apex court noted that assessee's relation with the agency was in the nature of principal and agent, that the agreement itself used the expression 'commission', and that it was not contested by assessee. It was also noted that payment of 15% was being made by the assessee to the agencies after collecting money from them and it was for securing more advertisements for them and to earn more business from the advertisement agencies.

Finally the transaction was held to be falling under the definition of expression 'commission' in the Explanation to Section 194H, observing that it is an inclusive definition giving wide meaning to said expression. The transaction in question, hence, did fall under the definition of expression 'commission' for the purpose of attracting rigor of Section 194H along with Section 201 of the Act. [*The Director, Prasar Bharati* v. *CIT* – Judgement dated 3-4-2018 in S.L.P.(C) Nos.3320-3321 of 2011, Supreme Court]

## Transfer Pricing - ALP for customised goods and commission paid to AEs - TNM method and not CUP to be followed

Bombay High Court has held that Transactional Net Margin Method (TNMM) and not the Comparable Uncontrolled Price (CUP) is the most appropriate method to arrive at Arm's Length Price (ALP) of customised goods sold to Associated Enterprises (AEs) abroad. The Court took same view for sales commission paid to those AEs. The assessee was engaged in the business of manufacturing of electric connectors, accessories, cable assemblies and system integrations for application in various industries such as military, aerospace and telecom, etc. The same were specialized and customized in nature, and goods were manufactured against only specific orders. It was noted that necessary Functions, Assets and Risk (FAR) analysis was conducted by Tribunal which concluded that price of goods sold to third parties is not comparable to price of goods sold to AEs.

Tribunal's view that there were geographical differences, volume differences, timing differences, risk differences, and functional differences between the goods, was upheld. Tribunal's view that CUP method would not be the most appropriate method in respect of commission paid to associated enterprises also was upheld observing differences in respect of function and geography between the AEs transaction and third party transaction in India. [*Amphenol Interconnect India v. Pr. CIT* – Judgement dated 7-3-2018 in ITA No. 1131, 1102, 1100 of 2015, Bombay High Court]

## Transfer pricing – Arm's length price determination – Parameters for inclusion or exclusion of companies

In a case involving determination of arm's length price for an assessee engaged in providing software and BPO services to its associated enterprise abroad, Delhi High Court has upheld Tribunal's view of inclusion of one firm and exclusion of two other for the purpose. While including a particular firm, the Court upheld the view taken by the TPO and the Tribunal and observed that said company's operation comprised of software development, implementation and support services, with primary segmental reporting based on geographical areas. It noted that said company's earnings were to a significant extent export oriented, separate books of account were maintained for the reported segments with revenue in the overseas segment came from export of software services, which are comparable to the assessee company.

In respect of exclusion from comparison, the Court upheld the view that the company did not qualify the employee cost filter, and was making persistent losses in software services segment. It observed that the said company also earned income from 'Business process outsourcing services', with no segmental information with respect to software services alone. Further, in respect of one more company which was also found to be not comparable, the Court observed that it was an abnormal company, as while sales were declining, receivables and write-offs were increasing. The Court in this regard also noticed that company was regularly incurring losses, and that declining turnover over the period indicated abnormal functional circumstances, which rendered it non-comparable. [*Steria India Ltd. v. Deputy Commissioner of Income* Tax – Judgement dated 9-4-2018 in ITA 403/2017, Delhi High Court]

## Recovery of dues may be made from purchaser of property under attachment by income tax department

The petitioner had purchased immovable property (industrial plots) from an assessee who have been served a notice of attachment of such property against demand of about INR 1,25 crores. The date of order and attachment was 26-3-2004 and the property had been purchased on 17-11-2006 though leasehold rights in respect of the same were not transferred to the petitioner by RIICO in view of the attachment. The department had appointed a Receiver for all attached properties as per Rule 70. In 2010, the department proceeded against the petitioner holding him to be assessee in default. The petitioner contended that in terms of Rule 68B of

Schedule II to the Income Tax Act, 1961, the department should have sold the property within 3 years from end of the financial year in which the order of attachment become final, failing which the attachment would deemed to have been vacated. The High Court, however held that since, at the time of purchase, the attachment had been in force the transaction was void and cannot become valid after 31-3-2007. Further, it noted that Rule 16 of the Schedule prohibits private transfer by the assesse in default which creates interest contrary to the attachment. It relied on the ruling of the Apex Court in *Macson Marbles*, (2008) 15 Supreme Court Cases, 481 to hold that the sale executed in favour of the petitioner would make the petitioner liable to pay the dues as against the defaulting company. Thus, it was held that the department could proceed against the purchaser (petitioner) as assessee in default. [*Premier Texto Trade P Ltd v. Tax Recovery Officer*, S.B. Civil Writ 8308/2010, judgement dated 12-4-2018, Rajasthan High Court]

## Earning of franchise fee by charitable education institution does not indicate business motive

Observing that larger objective of an educational/ charitable purpose of the institution and its manifestation can only be subjectively decided, Delhi High Court has held that Section 10(23C)(vi) of the Income Tax Act, 1961 has to be interpreted meticulously, on a case-to-case basis. The Court was of the view that educational institutions may have to take more creative steps to qualify their objectives as an “educational purpose” that is more universal than the individual objectives set out in their memoranda of objectives. Taking note of the fact that balance sheets of the assessee in the dispute demonstrated how the profits were utilized for the growth and maintenance of the very schools they were accrued from, thus, subscribing to a charitable motive, the Court allowed the writ petition filed by a school society running around 120 schools.

Deliberating over number of Apex Court decisions, the Court reiterated that the determining test to qualify for exemption under Section 10(23C)(vi) lies in the final motivation on which the institution functions, regardless of what extraneous profit it may accrue in its pursuit. It was held that interpretation of said section requires fulfilment of a two pronged test - first that business activity carried out by educational institution should be incidental to their educational purpose, and second, that proper accounts of such business activity have to be maintained. It was however held that such scrutiny is to be carried out every year, irrespective of the preceding pattern.

The department had earlier rejected application seeking exemption, on grounds that franchisee fee received by the assessee from satellite schools in lieu of its name, logo and motto amounts to a business activity with a profit motive. [*Director of Income Tax (Exemption) v. Delhi Public School* Society – Judgement dated 3-4-2018 in ITA 1086/2005 and Ors., Delhi High Court]

## AO cannot reopen assessment to disallow part of deduction allowed by CIT (A)

The Gujarat High Court has rejected AO’s impugned re-assessment notice disallowing part of expenditures which the CIT (A) had entirely allowed for deduction under Section 80IA (4) of Income Tax Act, 1961. It was noted that as CIT (A) had allowed the assessee’s claim of deduction under Section 80IA (4) of the Act, by re-assessment, the Assessing Officer would not be permitted to disturb such claim. The assessee in the present case was engaged in the business of developing, operating and maintaining infrastructure facility in respect of solid waste management system. Referring to another judgement of the court, it was held that when CIT (A) had allowed claim in its entirety, it would thereafter be not open for the Assessing Officer to reopen the very claim for possible disallowance of part thereof. It was noted that allowing such notice would result in violation of principle of merger. [*Gujarat Enviro Protection & Infrastructure v. Dy. CIT* – Judgement dated 7-3-2018 in SCA No. 16165 of 2017, Gujarat High Court]

## Transaction cannot be treated as sham merely because of economic detriment to revenue

ITAT Mumbai has rejected revenue's plea that the assessee had adopted a colourable method to avoid tax by showing long term capital loss on sale of shares against the profit of long term capital gain earned on sale of immovable asset. It was noted that the shares were sold by assessee at the fair market value and if the period co-existed or permitted the assessee to set off her capital loss against the capital gain earned, it would itself not give rise to the presumption that the transaction was in the nature of colourable device. The Tribunal in this regard observed that the sale of share was genuine being transacted at proper valuation followed with requisite procedure of transfer. It was held that the transaction cannot be treated as *non-est* merely on basis of some economic detriment or that it was prejudicial to interest of revenue. [*Madhu Sarda v. ITO* – Order dated 9-3-2018 in ITA No. 7410//Mum/2012, ITAT (Mumbai)]

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