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23 December 2020

Legal fees paid to a partnership firm taxable as fees for technical service under India-Japan DTAA

The Mumbai bench of the Income-tax Appellate Tribunal held that Article 14 of the India-Japan tax treaty (relating to independent personal services) deals with taxation of individuals only and legal fees paid to a partnership firm are taxable as fees for technical services under Article 12 of the India-Japan tax treaty.

Background:

- The taxpayer[1] is an Indian law firm and is assessed to tax in the status of a partnership firm.
- During audit proceedings for the Financial Year (FY) 2013-14, corresponding to Assessment Year (AY) 2014-15, the Assessing Officer (AO) noticed that the taxpayer had claimed foreign tax credit in respect of taxes withheld by its clients in Japan. The taxes so withheld were at the rate of 10% on gross billing amounts, by treating the professional fees earned by the taxpayer in Japan as taxable in Japan, i.e. the source country, under Article 12 of the India-Japan tax treaty (relating to taxation of royalties and fees for technical services).

  The AO was of the view that credit for such taxes withheld in Japan was not admissible to the taxpayer, since such income could only have been taxable under Article 14, dealing with 'independent personal services'. As the taxpayer did not have any fixed base in Japan, the condition precedent for taxability even under Article 14 (relating to taxation of independent personal services) was not at all satisfied.

  The AO was thus of the view that the taxes had been wrongly withheld in Japan, and, therefore, the taxpayer was not entitled to a foreign tax credit in respect of the same. The AO placed reliance on the decisions of the co-ordinate benches in earlier cases[2] in this regard and declined the foreign tax credit to the taxpayer.
- On appeal, the Commissioner of Income-tax (Appeals) [(CIT(A)] confirmed the AO's order.
- Aggrieved by the CIT(A)'s order, the taxpayer filed an appeal before the Mumbai Bench of the Income-tax Appellate Tribunal (ITAT).

[1] Amarchand & Mangaldas & Suresh A Shroff & Co. v. ACIT ITA No. 2613/Mum/19 (Mum ITAT)

[2] Maharashtra State Electricity Board Vs DCIT [2004] 90 ITD 793 (Mumbai ITAT); Dy. CIT v. Chadbourne & Parke LLP {2005] 2 SOT 434 (Mumbai ITAT), and Ershisanye Construction Group India (P.) Ltd. v. DCIT [2017] 84 taxmann.com 108 (Kolkata ITAT)

Extracts of relevant Articles of the India-Japan tax treaty:

- Article 12 (Royalties and fees for technical services):
  - The term 'fees for technical services' as used in this article means payments of any amount to any person other than payments to an employee of a person making payments and to any individual for independent personal services referred to in article 14, in consideration for the services of a managerial, technical or consultancy nature, including the provisions of services of technical or other personnel.
- Article 14 (Independent Personal Services):
  - The Income derived by a resident of a Contracting State in respect of professional services or other activities of an independent character shall be taxable only in that Contracting State unless he has a fixed base regularly available to him in the Contracting State for the purpose of performing his activities or he is present in that other Contracting State for a period or periods exceeding in the aggregate 183 days during any taxable year or 'previous year' as the case may be. If he has such a fixed base or remains in that other Contracting State for the aforesaid period or periods, the income may be taxed in that Contracting State but only so much of it as is attributable to that fixed base or is derived in that other Contracting State during the aforesaid period or periods.
  - The term 'professional services' includes especially independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, surgeons, lawyers, engineers, architects, dentists and accountants.
- Article 23 (Elimination of double taxation):

  As per Article 23(2)(a) of the India-Japan tax treaty, where a resident of India derives income which, in accordance with the provisions of this Convention, may be taxed in Japan, India shall allow as a deduction from the tax on the income of that resident an amount equal to the Japanese tax paid in Japan, whether directly or by deduction.

Decision of the ITAT:

- As per Article 23(2)(a) of the India-Japan tax treaty, when in accordance with the provisions of the India-Japan tax treaty, any income of an Indian resident was taxed in Japan, the Indian resident would get the deduction, in the computation of his tax liability for the taxes paid by the taxpayer in Japan, whether paid directly by the taxpayer or withheld in Japan.
- It was open to the AO to take a call on whether the taxes withheld in the treaty partner jurisdiction could be reasonably said to be in harmony with or in conformity with the provisions of the related tax treaty. In case the AO came to the conclusion that the taxes withheld in the treaty partner jurisdiction were reasonably not in harmony with the scheme of taxation in the tax treaty, he could decline the foreign tax credit under Article 23(2)(a) of the India-Japan tax treaty. The ITAT relied on a

judgement pronounced by[3] the Calcutta High Court and the OECD Model Convention Commentary, 2017 (earlier version) in this regard.

Hence, the ITAT noted that the question which needed adjudication was whether the taxpayer could reasonably be said to be taxable in Japan under Article 12 of the India-Japan tax treaty (relating to taxation of royalties and fees for technical services), in respect of the professional income earned in Japan.

Treaty should be read as whole; different articles cannot be read on a standalone basis

- There were overlapping areas in the definition of fees for technical services under Article 12(4) of the India-Japan tax treaty, which covered 'technical, management and consultancy services' vis-à-vis the definition of professional services (income from which could be taxed under Article 14 of the India-Japan tax treaty as 'income from independent personal services').

  This overlapping was recognised in Article 12(4) of the India-Japan tax treaty itself, as it provided that where fees from technical services sought to be taxed under Article 12 included any item of income which was dealt with in Article 14, Article 12 would yield to those specific provisions (in respect of that fee for technical service which could be taxed as income from independent services under Article 14 of the India-Japan tax treaty).

- The treaty approach was in consonance with the well-settled principle of law viz. general provisions do not override the specific provisions. When a particular type of income was specifically covered by a treaty provision, the taxability of that type of income was governed by the specific provisions so contained in the treaty.

However, it was equally well settled legal position that a treaty was to be read as whole and, therefore, different articles could not be read on a standalone basis *dehors* the scheme of the tax treaty. The ITAT relied on earlier case laws[4] (including that of the Supreme Court) in this regard.

Whether taxpayer could be reasonably said to be taxable in Japan under Article 12 of India-Japan tax treaty?

- The ITAT noted that:
  - Article 12(4) of the India-Japan tax treaty covered only payments to any individual for independent personal services covered in Article 14 of the India-Japan tax treaty.

    Normally an exclusion clause for independent personal services, as embedded in the article dealing with the fees for technical services (i.e. Article 12(4) of the India-Japan tax treaty), would cover only what was taxable under the head 'independent personal services'. It indicated that under the scheme of the India-Japan tax treaty what was taxable under Article 14 of the India-

[3] Nav Bharat Vanijya Vs CIT [1980] 123 ITR 865 (Calcutta HC)

[4] Hindalco Industries Ltd, v. ACIT [2005] 94 ITD 242 (Mumbai ITAT); DCIT v. Boston Consulting Group Pte Ltd [2005] 94 ITD 31 (Mumbai ITAT); K.P. Varghese v. ITO [(1981) 131 ITR 597 (SC)

Japan tax treaty was only the professional income of an individual and not of entities other than individuals.

On this aspect, there is a school of thought to the effect that Article 14 came into play only for individuals while Article 7 was for entities other than individuals, and it was for this reason that Article 14 was finally removed from the OECD Model Convention. The ITAT relied on an earlier case[5] of the co-ordinate bench in relation to the above.

- In view of the above, the ITAT observed that:
  - There is a valid school of thought that in the scheme of the India Japan tax treaty, Article 14 for independent personal services held the field for individuals only - particularly in the light of the exclusion clause under Article 12(4) being restricted to payment of fees for professional services to individuals alone.

    There was no dispute that the provisions of Articles 14 and 12 of the India-Japan tax treaty were overlapping in as much as what was termed as professional service, could also be covered by the fees for technical service.
  - As per the AO specific provisions of Article 14 of the India-Japan tax treaty had to make way for rather general provisions of Article 12 of the India-Japan tax treaty. However, the said proposition ceased to hold good in the present case since in the context of India Japan tax treaty, Article 14 of the India-Japan tax treaty came into play only for individuals.

    As a corollary, the exclusion clause under Article 12(4) not being triggered on the facts of the case under consideration, it was indeed reasonably possible to hold that the payments in question were rightly subjected to tax withholding in Japan.

Based on the above, the ITAT held that:

- The legal fees paid to a partnership firm of lawyers could indeed be subjected to levy of tax under Article 12 of the India-Japan tax treaty as the exclusion clause under Article 12(4) of the India-Japan tax treaty did not get triggered for payments to persons other than individuals, and the provisions of Article 14 of the India-Japan tax treaty were required to be read in harmony with the provisions of Article 12(4) of the India-Japan tax treaty.
- The conclusions arrived at by the Japanese tax authorities, directing tax withholdings from the payments made to the taxpayer by its Japanese clients, were not unreasonable or incorrect and the taxpayer was wrongly declined credit for tax withheld in Japan.

Based on the above, the ITAT directed the AO to grant credit to the taxpayer for the taxes withheld in Japan.

The ITAT separately observed the following:

[5] Linklaters LLP Vs ITO [2011] 9 ITR 217 (Mum ITAT)

- As far as determination of question as to whether taxation had been done in the source country "in accordance with the provisions of this Convention, may be taxed in … (the source jurisdiction)", one had to take a judicious call as to whether the view so adopted by the source jurisdiction was reasonable and bonafide, which may or may not be the same as the legal position in the residence jurisdiction.

  While it was desirable that there should be uniformity in tax treaty interpretation in the treaty partner jurisdictions, it was not always be possible to do so in view of a large variety of variations, such as the sovereignty of judicial systems, domestic law overrides on the treaty provisions, legal framework in which the treaties were to be interpreted, and the judge-made law in the respective jurisdictions. In a situation in which a transaction by resident of one of the contracting states was to be examined in both the treaty partner jurisdictions, from the point of view of taxability of income arising therefrom, different treatments being given by the treaty partner jurisdictions would result in incongruity and undue hardship to the taxpayer.

  In light of the above, the ITAT noted that the Japanese tax authorities had consciously taken a call by rejecting taxpayer's plea for non-taxation and by proceeding against the taxpayer's Japanese clients for interest and penalties for non-deduction of tax at source from the payments in question. Accordingly, the ITAT held that this view was a reasonable view in the context of India-Japan tax treaty and, at the minimum, not 'manifestly erroneous' – even though it was not the same as was the view taken by the residence jurisdiction (i.e. India in the current case).

Comment:

This ruling lays down the following principles:

- Legal fees paid to a partnership firm of lawyers could be subjected to levy of tax under Article 12 of the India-Japan tax treaty.
- The exclusion clause under Article 12(4) of the India-Japan tax treaty does not get triggered for payments to persons other than individuals.
- Article 14 of the India-Japan tax treaty (relating to independent personal services) deals with taxation of individuals only.

Taxpayers with similar facts may want to evaluate the impact of this ruling to their specific facts.

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