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Non-compete fees for employment services rendered in US are not taxable in India as per India-USA tax treaty

The Karnataka High Court rendered its decision that non-compete fees paid to key employees (who perform services and receive payments in the USA) qualify as salary and are taxable only in the USA as per Article 16 of India-USA tax treaty.

Facts of the case:

- Sasken Communication Technologies Ltd (taxpayer)[1] is an Indian company specialising in product engineering and digital transformation by providing concept-to-market, chip-to-cognition research and development services to various industries.
- The taxpayer's subsidiary (Subsidiary) had employed a Chief Executive Officer and a Chief Operating Officer (Employees) with effect from 1 April 2004. The Subsidiary merged with the taxpayer on 1 April 2005. The taxpayer thereafter offered and the Employees accepted employment with the taxpayer.
- The taxpayer entered into three contracts with the Employees viz. Employer Agreement, Non-Disclosure Agreement (NDA) and Employee Non-Compete Agreement (ENCA).
- The payment under the ENCA was made after the Employees had accepted employment with the taxpayer. This payment was remitted without deducting tax at source (TDS) on the basis that the payment was covered by Article 16(1) of the India-USA Tax Treaty (tax treaty) relating to taxation of Dependent Personal Services.
- The Assessing Officer (AO) on enquiry of the payment, held that:
  - The agreements and the payment thereunder to the Employees was a sham and created for avoidance of tax in India;
  - Tax had to be deducted by taking assessee in default.

  The AO also levied interest on the taxpayer.
- On appeal, the Commissioner of Income-tax Appeals [CIT(A)], upheld the AO's order on the following basis:
  - The Employees were prohibited from taking employment with competitors of the taxpayer based in India and the prohibition operated in India;
  - The rights and obligations of the Employees under the ENCA were to take effect in India.

[1] DIT v. Sasken Communication technologies ltd [2020] 117 taxmann.com 278 (Kar. HC)

- Income under the ENCA arose in India and the payments were not from employment or in the nature of profits in lieu of salary.
- The non-compete fees paid to the Employees were taxable under Article 23(3) of the India-USA tax treaty relating to taxation of Other Income.

- On further appeal, the Bangalore Bench of the Income-tax Appellate Tribunal (ITAT) held that the payment to Employees under the ENCA were in the nature of salaries which were not taxable in India as per Article 16 of the India-USA tax treaty. Accordingly, the taxpayer was not in default for making payment under the ENCA without deducting TDS.
- Aggrieved by the ITAT's order, the Revenue filed an appeal before the Karnataka High Court (HC).

Decision of the HC:

- Based on the provisions of the Indian domestic tax law, the HC noted the following in relation to the taxability of salary income of a non-resident:
  - Income of a non-resident shall be treated as salary, if it is earned in India and for the services rendered in India;
  - Salary definition includes any fees, commission, perquisites or profits in lieu of or in addition to any salary or wages;
  - Expression "profits in lieu of salary" includes any amount received in lump sum or otherwise by a taxpayer before joining any employment or after cessation of employment.

  Further, the HC noted that as per Article 16(1) of the India-USA tax treaty, salaries, wages and other similar remuneration derived by a resident of the USA in respect of an employment should be taxable only in the USA, unless the employment is exercised in India.
- The HC noted the following key findings of the ITAT:
  - The payment under the ENCA was made after the Employees had accepted employment with the taxpayer;
  - The Employees occupied higher positions in the Subsidiary and were in possession of vital and confidential information. Therefore, the Employees were required to be retained in the interest of the taxpayer carrying on its business effectively;
  - The transactions were not sham;
  - The Employees rendered services in the USA and payments were made in the USA;
  - The income of the Employees qualified as salary / profit in lieu of salary and was taxable only in the USA as per Article 16 of the India-USA tax treaty. Thus, the taxpayer was not required to withhold TDS and was not in default.

  The HC held that no material was placed on record to demonstrate that the factual findings of the ITAT were perverse. Considering that the ITAT concluded the matter by findings of fact and the Revenue did

not plead or place on record material to show that the findings were perverse, the HC held that no substantial question of law arose for consideration.

- With respect to the Apex Court rulings[2] relied upon by the Revenue, the HC held that the same were distinguishable based on facts, since in those cases the services were performed / rendered in India and in the case under consideration, the services were rendered in the USA.
- In view of the above, the HC dismissed the Revenue's appeal as no question of law arose for consideration.

Comments:

- Characterisation of an income based on facts is subject matter of litigation. This ruling lays down the principle that non-compete fees qualify as salary based on facts and accordingly, covered under Article 16 under the India-USA tax treaty, relating to Dependent Personal Services.

[2] Performing Right Society Ltd. v. CIT (1977) 106 ITR 11 (SC) and Pilcom v. CIT [2020] 116 taxmann.com 394 (SC)

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