Tax Hotline

February 11, 2019

DELHI TRIBUNAL: LLP INCOME TAXABLE AS INCOME FROM INDEPENDENT PERSONAL SERVICES

- LLPs providing professional services are entitled to claim the benefit of treaty provisions on independent personal services
- As a corollary, LLPs providing business services or other services may be taxed in the same manner as any other foreign enterprise
- Income taxable as fees for technical services only if "make available" requirements are satisfied

Recently, in *ACIT v. Grant Thornton*,[1] the Delhi bench of the Income-tax Appellate Tribunal ("**Tribunal**") held that income derived by foreign limited liability partnerships (LLPs) from providing legal and accounting services to an Indian taxpayer would be taxable on a residence basis as income from independent personal services under applicable international tax treaties.

BACKGROUND

The taxpayer was a partnership firm providing international accounting and advisory services to its clients in India and abroad. For the assessment year in consideration (AY 2010-11), the taxpayer had filed its return of income declaring its total income at INR 6,46,22,387.

During the course of scrutiny proceedings initiated against the taxpayer under section 143(2) of the Income-tax Act, 1961 ("**ITA**"), the Assessing Officer ("**AO**") noticed that the taxpayer had claimed deductions totaling INR 1,41,08,805 against payments made to certain foreign LLPs for rendering professional services to the taxpayer's overseas clients in the UK, the USA, France, and the Netherlands. The taxpayer had not withheld tax at source on these payments on the basis that they constituted income from independent personal services, which was not taxable in India under India's international tax treaties with the UK, the USA, France and the Netherlands. However, the AO rejected this argument on the basis that the provisions on independent personal services in the relevant tax treaties only applied to income derived by individuals, whether in their own capacity, or as members of partnership firms, and not to income derived by LLPs (i.e., entities distinct from their members). The AO therefore recharacterized these payments as fees for technical services (FTS) and disallowed the entire amount under section 40(a)(i) of the ITA for failure to withhold tax at source.

On appeal, the disallowance was deleted by the Commissioner of Income-tax (Appeals) ("**Commissioner**"). On reviewing the provisions on independent personal services in India's tax treaties with the UK, the USA, France and the Netherlands, the Commissioner was of the opinion that these provisions were "definitely applicable" to income derived by both partnership firms and LLPs, and that the AO had rejected the taxpayer's arguments on a "flimsy" basis. Accordingly, the Commissioner held that the payments constituted income from independent personal services, which were not taxable in India, as the thresholds for triggering source taxation of such income had not been crossed under any of the relevant tax treaties. The Commissioner also found that the payments did not constitute FTS as no technical knowledge had been 'made available' to the taxpayer in lieu of these payments. In either case, since the income itself was non-taxable, the question of withholding tax at source did not arise.

Aggrieved by the order of the Commissioner, the Revenue appealed to the Tribunal.

RULING OF THE TRIBUNAL

The Tribunal dismissed the Revenue's appeal and affirmed the Commissioner's order on both counts, thereby allowing the taxpayer's claim for deductions against payments made to foreign LLPs.

The Tribunal concurred with the Commissioner's finding that the provisions on independent personal services in the relevant international tax treaties were applicable to income derived by individuals, whether in their own capacity, or as members of partnership firms, and therefore did not find any error in the Commissioner's order. The Tribunal did not specifically address the AO's argument that the provisions on independent personal services were not applicable to LLPs.

The Tribunal noted that the provisions on FTS under the relevant tax treaties were attracted only if some technical knowledge had been 'made available' to the taxpayer in the process of providing professional services to the taxpayer's overseas clients. As the Revenue had failed to establish that any technical knowledge had been made available to the taxpayer, the Tribunal applied the more beneficial provisions of the relevant tax treaties over the provisions of the ITA (which did not contain a 'make available' requirement for a payment to qualify as FTS), and held that the payments did not constitute FTS, and hence, were not subject to tax withholding requirements under the ITA.

ANALYSIS

While the ruling is certainly welcome from a taxpayer perspective, the Commissioner's and the Tribunal's analysis of the law appears incomplete and could result in incongruous situations as pointed out below. Not only have both

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authorities failed to note or appreciate crucial differences in the provisions on independent personal services in the relevant tax treaties (i.e., India's treaties with the UK, the USA, France, and the Netherlands), both authorities also appear to have ignored prior (diverging) precedent on the issue as well.

Importantly, each of the four tax treaties applicable to the facts in issue differ in their personal scope:

Treaty	Treaty Text	Scope
India – UK	"*Income derived by an individual, whether in his own capacity or as a member of a partnership (…)*"	Individuals
India – US	"*Income derived by a person who is an individual or firm of individuals (other than a company) (…)*"	Individuals and partnership firms
India – France	"*Income derived by an individual or a partnership of individuals (…)*"	Individuals and partnership firms
India - Netherlands	"*Income derived by a resident of one of the States (…)*"	All residents, irrespective of form of entity

From a bare reading of the treaty texts, it is immediately evident that: (i) the India – UK tax treaty ("**UK Treaty**") is only applicable in respect of income derived by individuals from the independent personal services; (ii) India's treaties with the USA and France ostensibly cover income derived by partnership firms from independent personal services, although the scope of the term "partnership firm" is unclear in both cases; and (iii) the India – Netherlands tax treaty ("**Netherlands Treaty**") covers income derived by all 'residents' from independent personal services and therefore has the widest personal scope among the treaties under discussion. Even in relation to the Netherlands Treaty (the most expansively worded of the treaties under discussion), it is pertinent to note that the United Nations Model Double Taxation Convention ("**UN Model Convention**") observes that the article on independent personal services (which is worded similarly in both the Netherlands Treaty and the UN Model Convention) is intended to apply only to income derived by individuals.[2] This nuance appears to have been glossed over by both the Commissioner and the Tribunal.

Notwithstanding this textual analysis, Courts have delivered diverging judgements on the applicability of the provisions on independent personal services to partnership firms. In *Linklaters LLP v. ITO*,[3] the Mumbai bench of the Tribunal held that article 15 of the UK Treaty (relating to income from independent personal services) would be applicable only in respect of services rendered by an individual, while article 5(2)(k) (relating to service PE) would be applicable in respect of services provided by an enterprise. The reasoning in *Linklaters* has been affirmed by the Mumbai bench of the Tribunal in two subsequent cases relating to the same taxpayer and the same tax treaty, but for different assessment years, where the Tribunal stated that article 15 of the UK Treaty would be applicable for determine taxable income in the hands of individuals, and not other persons.[4] In *Aditya Birla Nuvo Ltd v. ADIT*,[5] the Mumbai bench of the Tribunal applied article 5 (relating to PE) of the India – Italy tax treaty ("**Italy Treaty**"), without discussion, to determine the taxability of an Italian company in India, even though the taxpayer had argued for the applicability of article 15 (relating to income from independent personal services).[6]

While certain cases have applied the provisions on independent personal services to income derived by corporate entities (including LLPs), these cases have been uniformly rendered in the backdrop of treaties worded in the same expansive manner as the UN Model Convention and the Netherlands Treaty.[7] A notable exception here is the decision of the Mumbai bench of the Tribunal in *DCIT v. Chadbourne & Parke LLP*,[8] where the provisions on independent personal services under the India – US tax treaty ("**US Treaty**"), which are far more narrowly worded than the UN Model Convention or the Netherlands Treaty,[9] were applied to determine the taxability of income derived by a US LLP from providing legal services in India.[10] However, it is crucial to note that the Tribunal in this case did not examine whether the provisions on independent personal services would be applicable to legal persons in principle, but merely proceeded on the assumption that they were.[11] In applying these provisions, the Tribunal relied on the prior decisions in *MSEB v. DCIT* and *Graphite India Ltd v. DCIT*,[12] even though neither of those decisions had addressed the issue in principle either. More importantly, these decisions create a tax mismatch by effectively treating an LLP providing independent personal services as tax transparent, even though it may not be treated as such under the laws of its home jurisdiction, while at the same time, treating it as tax opaque for other purposes (for instance, where the LLP is providing other technical or business or support services). Consequently, this approach may potentially limit the LLP's ability to claim foreign tax credit in its home jurisdiction against taxes paid in India, since it could be argued that the Indian taxes were actually borne by the partners / members of the LLP, and not by the LLP itself. The question of who is the "resident" that is paying taxes and is therefore entitled to claim credit could cause issues, similar to the case of trusts.

The divergence in opinion on whether the provisions on independent personal services applied to legal persons was one of the factors behind the OECD's decision to delete these provisions from the OECD Model Tax Convention on Income and Capital ("**MTC**").[13] After taking on record the observations made in the UN Model Convention and acknowledging that the Commentaries on the articles of the MTC did not directly deal with the issue, the OECD stated that it "*could not see any justification for imposing different rules to services depending on whether they were provided by an individual (Article 14) or a legal person (Article 7)*",[14] thereby implying that the provisions on independent personal services were limited to services provided by individuals.[15] It was agreed that if there were significant practical differences between the rules of Article 7 and Article 14, large professionals and incorporated professionals would be treated differently from independent service providers, despite their being no legal or commercial justification for doing so.[16]

Seen in this light, it is unusual that a considerable number of cases, including the decision in *Grant Thornton*, have nevertheless witnessed the provisions on independent personal services being applied to legal persons. With the increasing use of corporate forms in the supply of cross-border services, it would therefore be imperative to clarify the

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personal scope of these provisions to provide certainty to taxpayer and ensure uniformity in tax administration. Till such time, taxpayers providing professional services should mostly continue to benefit from being classified as providing independent personal services, except where taxes are actually payable in India, in which case, the issue of claiming credit in the home jurisdiction could potentially crop up.

– Anandu Unnikrishnan & Meyyappan Nagappan

You can direct your queries or comments to the authors

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[1] Order dated 10.11.2019 in ITA No. 4143/Del/2015 for AY 2010-11.

[2] *See* Commentary on article 14, UN Model Convention (2017), at pages 384 – 385. At page 385, the Commentary observes that "*It was generally agreed that remuneration paid directly to an individual for the performance of activity in an independent capacity was subject to the provisions of Article 14. Payments to an enterprise in respect of the furnishing by that enterprise of the activities of employees or other personnel are subject to Articles 5 and 7 (…) If the parties believe that further clarification of the relationship between Article 14 and Articles 5 and 7 is needed, they may make such clarification in the course of negotiations.*"
The Commentary on the previous edition of the UN Model Convention (2011) stated this more expressly, at page 114: "*It should be noted that subparagraph (c), in attempting to reflect the operation of the current Article 14, paragraph 1, subparagraph (b), more explicitly indicates that the subparagraph only applies to individuals. In this respect, it follows and makes clearer the interpretation found in paragraph 9 of the Commentary on Article 14, to the effect that Article 14 deals only with individuals. The Committee notes that some countries do not accept that view and should seek to clarify the issue when negotiating Article 14.*"

[3] [2010] 132 TTJ 20 (Mumbai), relating to AY 1995-96.

[4] Linklaters LLP v. DCIT, [2017] 185 TTJ 525 (Mumbai – Trib.), relating to AY 2011-12, at paras 34 – 35; and Linklaters LLP v. DCIT, [2018] 172 ITD 459 (Mumbai – Trib.), relating to AY 2012-13, at paras 23 – 24. *Also see* the decision in Christiani & Nielsen Copenhagen v. First ITO, [1991] 39 ITD 355 (Bombay).

[5] [2011] 44 SOT 602 (Mumbai).

[6] The language of article 15 of the Italy Treaty is comparable to the language employed in corresponding provisions in the Netherlands Treaty and the UN Model Convention.

[7] *See* MSEB v. DCIT, [2004] 90 ITD 793 (Mum.) (in the context of the erstwhile UK Treaty, prior to its substitution in 1993); DIT v. Paper Products Ltd, [2002] 257 ITR 1 (Delhi) (in the context of the Italy Treaty); CIT v. Sweta Estates (P.). Ltd, [2012] 28 taxmann.com 414 (Delhi) (in the context of the India – China tax treaty).

[8] [2005] 93 TTJ 734 (Mumbai).

[9] Please see the table above for how the provisions on independent personal services under the US Treaty are worded.

[10] While a similar decision was arrived at by the Mumbai bench of the Tribunal in *IMP Power Ltd v. ITO*, [2007] 107 TTJ 522 (Mumbai) (in the context of the UK Treaty, as it stands today), this decision is almost certainly incorrect as it followed MSEB v. DCIT, which was rendered in the context of the erstwhile UK treaty, which was worded differently.

[11] Similar approaches were adopted in the twin rulings of the Mumbai bench of the Tribunal and the Bombay High Court in another set of cases relating to a major UK law firm: Clifford Chance v. DCIT, [2002] 82 ITD 106 (Mum.); and Clifford Chance v. DCIT, [2009] 318 ITR 237 (Bombay).

[12] [2003] 86 ITD 384 (Kol.).

[13] *See* OECD, *Issues Related to Article 14 of the OECD Model Tax Convention* (2000), available at https://www.oecd-ilibrary.org/content/publication/9789264181236-en (last accessed on February 4, 2019).

[14] *Id.*, at 10. A similar observation is found in the 2017 update to the Commentaries on the articles of the MTC: "*Article 14 was deleted from the Model Tax Convention on 29 April 2000 (…) That decision reflected the fact that there were no intended differences between the concepts of permanent establishment, as used in Article 7, and fixed base, as used in Article 14, or between how profits were computed and tax was calculated according to which of Article 7 or 14 applied. In addition, it was not always clear which activities fell within Article 14 as opposed to Article 7. The effect of the deletion of Article 14 is that income derived from professional services or other activities of an independent character is now dealt with under Article 7 as business profits.*"

[15] *Id.*, at page 10: importantly, the OECD noted that countries such as Mexico and Turkey had made observations to the commentary on Article 14 by officially taking the position that Article 14 applied to legal persons.

[16] Id., at page 11.