Newsflash:
Karnataka High Court Rules - No TDS on reimbursement of seconded employees' salary and directs Revenue to issue Nil TDS certificate

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Newsflash

Karnataka High Court Rules - No TDS on reimbursement of seconded employees' salary and directs Revenue to issue Nil TDS certificate

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1.0 BACKGROUND

1.1 Secondment of employees of foreign entity to Indian group entities has been followed consistently as a general practice to support the Indian operations of the multinational enterprises. The taxability of secondment arrangements and corresponding payments have been subject to judicious examination under direct and indirect tax law over the past many years.

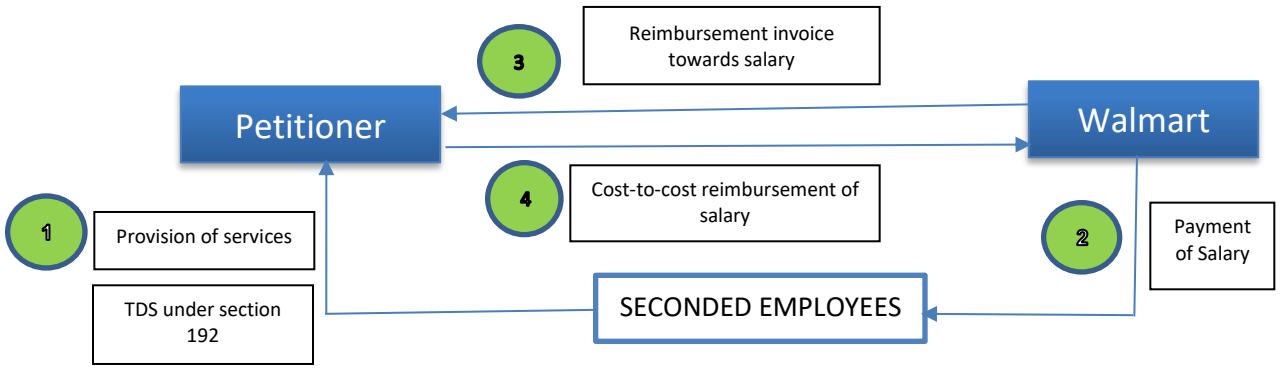
1.2 Recently, **Hon'ble Karnataka High Court ('HC')** has analysed this issue in detail and delivered a judgment on 24 June 2022 in the case of **M/s Flipkart Internet Private Limited**[1] **('Flipkart' or 'the Petitioner')**. The ruling has been pronounced in respect of a writ petition filed by the Petitioner against the order passed by the Assessing Officer ('AO' or 'the Revenue') rejecting the application for 'Nil TDS certificate' wherein Hon'ble HC has held that there is no requirement to deduct TDS on reimbursement of seconded employees' salary. The judgment has been discussed in detail in the ensuing paragraphs.

2.0 FACTS OF THE CASE

2.1 The Petitioner is a private limited company incorporated in India. It is engaged in the business of providing Information Technology Solutions and Support Services for the e-commerce industry.

2.2 During the Assessment Year ('AY') 2020-21, Walmart Inc. ('Walmart'), a non-resident company incorporated in United Stated of America ('USA') and holding majority shares of the Petitioner, seconded four of its employees to the Petitioner and entered into an arrangement with the seconded employees by virtue of which the seconded employees would work for the benefit of Petitioner. As per the arrangement of secondment, the salary of the seconded employees was first paid by Walmart for administrative convenience and was to be subsequently reimbursed by Petitioner on cost-to-cost basis. Petitioner deducted tax at source ('TDS') under section 192 of the Income Tax Act, 1961 ('the Act') on such amounts. The diagrammatic representation of the facts is as below:

[1] **TS-503-HC-2022(KAR)**



2.3 With respect to payment towards reimbursement of salary paid by Walmart to seconded employees, a certificate of 'Nil TDS' was sought by the Petitioner vide an application under section 195(2) of the Act to allow the Petitioner to make the payment without TDS.

2.4 The AO rejected the application and passed an order directing the Petitioner to deduct tax under section 195 of the Act, against which the Petitioner preferred the writ petition before the Hon'ble Karnataka HC.

3.0 CONTENTIONS BEFORE HIGH COURT

Contentions of the Petitioner

3.1 Payment made by the Petitioner was mere cost-to-cost reimbursement with no markup of the salary paid by Walmart to the seconded employees, thereby, not generating any income in the hands of Walmart. Therefore, the Petitioner could not be held liable to deduct tax under section 195 of the Act since the section provides for deduction only when the 'sum paid' is 'chargeable to tax' under the Act in the hands of the non-resident recipient.

3.2 The amount paid by the Petitioner could not be regarded as Fee for Included Services ('FIS') within the ambit of Article 12 of India-USA Double Tax Avoidance Agreement ('DTAA') since Article 12 provides the condition of **make available** and can bring to tax only such payments which make technology available to the person acquiring the services so as to equip the service recipient to apply the technology or technical knowledge by itself once the service has been rendered. The Petitioner contended that no technical know-how or skill was 'made available' to it by the seconded employees and thus, the payment was to be excluded from the provisions of Article 12 of DTAA.

3.3 The payment made by it was reimbursement of salary and once the payment could be characterized as salary, the same would be out of the purview of Article 12 and Article 16 of DTAA. Considering salary payment, tax would be deducted under section 192 of the Act, thus the provisions of section 195 of the Act are not applicable.

3.4 Placing reliance on the law laid down by Apex Court in **Azadi Bachao Andolan**[2] and **Engineering Analysis Centre of Excellence Private Limited**[3] and section 90(2) of the Act, it was contended that the beneficial provisions of DTAA would prevail over the domestic law and the salary payment could not be treated as FIS by invoking the provisions of section 9 of the Act.

3.5 The Petitioner highlighted that vide the service agreement between Flipkart and Walmart, Flipkart was granted an unconditional right to terminate the employment of seconded employees. Therefore, the Petitioner can be considered to be the real and economic employer of such seconded employees.

3.6 It was also emphasized that the Petitioner had a well-developed and established business model in India much before Walmart became its majority equity holder and was not a mere back office for Walmart. On this basis, the petitioner has differentiated their facts with the case relied upon by the respondents of ***Centrica India Offshore (P.) Ltd. Vs Commissioner of Income Tax, New Delhi*** wherein the non-resident entity had seconded its employees to the new incorporated Indian subsidiary and the Indian subsidiary was specifically incorporated to provide back office support services in relation to third party vendors in India.

Contentions of Revenue

3.7 The Petitioner's recourse to section 195(2) of the Act to avail Nil TDS certificate was objected to be not applicable as the said section provides for determination of appropriate portion of sum chargeable to tax and not nil taxation.

3.8 Employer-employee relationship between Flipkart and the seconded employees was stated to be non-existent and it was contended that seconded employees remained in employment of Walmart even during the period of secondment.

3.9 The services rendered by seconded employees were in the nature of technical services as such employees were offered senior positions in management only because of their managerial and consultancy experience and thus, payment for these services would fall under Fee for Technical Services ('FTS') in terms of section 9(1)(vii) of the Act.

3.10 The obligation of tax deduction under section 195 cannot be obviated by TDS under section 192. The Revenue hereby contended that tax under section 195 of the Act has to be deducted on gross payment, thus the question of examination of income element embedded in the payment is of no relevance.

3.11 Lastly, the Revenue also placed reliance on the judgment under erstwhile service tax regime of **Apex Court** in the case of **M/s Northern Operating Systems Pvt. Ltd**[4]**,** wherein it has been held that

[2] (2003) 263 ITR 706 (SC)
[3] (2021) 432 ITR 471
[4] Civil Appeal Nos. 2289-2293/2021

traditional test of control cannot be the sole determinative factor to indicate the real employer. Reliance was also placed on the judgment of **Hon'ble Delhi HC** in the case of **Centrica India Offshore (P.) Ltd[5],** wherein secondment arrangement was disregarded, and it was held that the nomenclature cannot be a determinative factor and mere payment of costs where the entities are related would not take such payment out of the consideration of the necessity to deduct tax.

4.0 OBSERVATIONS OF THE HON'BLE KARNATAKA HIGH COURT

4.1 Whether the petitioner's recourse to section 195(2) of the Act for obtaining a Nil TDS certificate was non maintainable?

Hon'ble HC has highlighted that the stand of non-maintainability of the application has been made by the Revenue in response to the Petitioner's plea for setting aside of the impugned order and not at the time of rejecting the application. Thus, no fresh contentions can be placed to enlarge the judicial review of the impugned rejection order and consider the substantial aspects which were not considered by the Revenue earlier.

Placing reliance on the ruling in the case of **Bovis Lend Lease (India) (P.) Ltd.**[6] and **Transmission Corpn. of A.P. Ltd.**[7], it has been observed that the Petitioner's recourse to section 195(2) of the Act is perfectly in consonance with the object of section 195 as the said provision deals with an application made by the payer as against the application under section 197 of the Act which is made by the recipient of an income.

Hon'ble HC also differentiated from the Revenue's contention of no requirement to obtain certificate under section 195(2) or 197 of the Act if the payer is of the view that the amount is not chargeable to tax and highlighted that a payer is not barred from invoking such a provision to safeguard itself from the unfavorable provisions of section 40(a)(i), penal provisions of section 201 and prosecution provisions of section 276B of the Act.

4.2 Whether the said payment would fall within the ambit of FTS/ FIS and tax deduction is required under section 195(2) read with Article 12(4) of India-USA DTAA?

While comparing the provisions of section 195 of the Act, which requires tax deduction on payment of 'any sum chargeable to tax', with definition of FTS under Explanation 2 to section 9(1)(vii) of the Act and Article 12 of India-USA DTAA, which provides scope of FIS, Hon'ble HC held that Article 12 is more beneficial to the Petitioner and is therefore applicable in terms of section 90(2) of the Act.

Hon'ble HC highlighted that Article 12(4)(b) requires rendering of technical or consultancy services and at the same time, such technical knowledge must be made available to the service recipient, which in the present case has not been fulfilled. Even the secondment agreement does not support 'make available'. Thus, the payment made cannot be regarded as FIS under Article 12 of India-USA DTAA.

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[5] (2014) 227 Taxmann 368 (SC)
[6] [2012] 208 Taxmann 168 (Kar)
[7] [1999] 105 Taxmann 742 (SC)

4.3 Deduction u/s 195(2) of the Act on the 'sum chargeable under this Act'

The Hon'ble HC observed that the DCIT has grossly erred while concluding that where the payment is made for the services rendered, then whether the charge for the services rendered is equivalent to the cost or not becomes irrelevant. The finding that the services rendered fall within the description of services as in Explanation-2 in Section 9(1)(vi) and that the element of profit is not an essential ingredient of receipt, to make it taxable is erroneous.

4.4 Whether the TDS under section 195 of the Act is to be made on gross remittance?

This issue has been analyzed by taking recourse to the comparison between the readings of sections 194J and 194C with the expression used in section 195. While the former sections use words *"at the time of credit of sum to the account of the payee or at the time of payment thereof in cash…",* the latter specifically uses the expression *"any other sum chargeable under the provisions of this Act"*.

Hon'ble HC relied upon the judgment of **Hon'ble Supreme Court ('SC')** in the case of **GE India Technology Centre Private Limited**[8], wherein Hon'ble SC highlighted that section 195 falls under Chapter XVII which deals with collection and recovery, while Chapter XVII-B deals with TDS by payer and concluded that **withholding obligation under section 195(1) arises only if the payment is chargeable to tax in the hands of non-resident recipient**. Accordingly, Hon'ble HC rejected the contention of Revenue regarding TDS on gross basis.

4.5 Whether the Petitioner is an employer of the seconded employees in substance?

On a detailed analysis of the service agreement between Flipkart and Walmart and other facts available on record, Hon'ble HC noted the following:

a. Flipkart issued employment letters to the secondees and also had the right to terminate their services.
b. Secondees were liable to report to Flipkart.
c. The party placing the secondees (i.e., Walmart) could invoice the party receiving services from such secondees (i.e., Flipkart) for the secondment costs, expenses and incidental costs incurred.
d. The power to decide on the continuance of the secondees by Walmart post secondment period would not make any impact on employer-employee relationship between Flipkart and seconded employees during the secondment period.
e. Flipkart was not merely acting as a back office for providing support services to the overseas entity rather was a fully functional company with an already established business model.
f. Revenue placed reliance in case of Northern Operating Systems (supra) wherein Apex Court, while construing a secondment contract in which employees were seconded to Indian company by foreign group company, had held that in a secondment arrangement, a secondee would continue to be employed by original employer. Apex court ruled secondment arrangement as 'supply of manpower service' by foreign employer for the purpose of service tax. The principles laid in Northern Operating Systems were not considered useful by Hon'ble HC in the instant

[8] (2010) 10 SCC 29

case with a view that legal requirement calls for a determination as to whether the services are in the nature of FIS in light of further requirement of 'make available'.

4.6 Distinction from Centrica India Offshore (supra)

The judgment of Centrica India Offshore has been distinguished on the basis of facts as under:

Issue examined	Centrica India Offshore	Instant case
Whether 'make available' fulfilled	Services rendered constituted 'included service' that made available skill to the other party.	'Make available' test is not fulfilled to qualify FIS
Real employer vs. economic employer	Overseas entity had overriding control over the employment, thus approving existence of Service PE.	Flipkart is the real employer and no Service PE is constituted.
Nomenclature vis-a-vis nature of payment	Mere nomenclature as reimbursement and the fact that payment of cost is made to related party cannot be the determinative factors to rule out necessity to deduct tax.	The payment made by Flipkart was considered as reimbursement in the true sense.

5.0 FINAL RULING BY HON'BLE HIGH COURT

- The principle laid in case of GE India (supra) that 'The fact that the Revenue has not obtained any *information cannot be a ground to construe section 195 widely to require TDS deduction even in a case where an amount paid is not chargeable to tax at all*" is reiterated and followed';
- There is no question of prejudice to the Revenue at the stage of section 195 as question of final liability of recipient arises subsequently;
- Revenue's contention of non-existence of employer-employee relationship between Flipkart and seconded employees was rejected following the judgment in the case of **Abbey Business Services India (P) Ltd**[9].
- Rejection order under section 195(2) is set aside and directions have been given to Revenue to issue 'Nil TDS' certificate.

[9] (2020) 122 Taxmann.Com 174 (Kar)

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This Newsflash summarizes the Karnataka HC ruling which allowed Flipkart's writ petition regarding no TDS on reimbursement of seconded employees' salary and directed the Revenue to issue Nil TDS certificate**.** It may be noted that nothing contained in this newsflash should be regarded as our opinion and facts of each case will need to be analyzed to ascertain applicability or otherwise of the said judgement and appropriate professional advice should be sought for applicability of legal provisions based on specific facts. We are not responsible for any liability arising from any statements or errors contained in this newsflash.

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