Payment by an Indian animation film production company to foreign sub-contractor for creating ‘production material’ is not Fees for Technical Services

30 April 2014

Background

The Hyderabad Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of DQ Entertainment (International) P. Ltd. (the taxpayer) held that payment made by Indian animation film production company to a foreign sub-contractor for creating ‘production material’ is not in the nature of Fees for Technical Services (FTS) and accordingly, not liable to withholding of tax in India.

Further, the taxpayer’s business alongwith its overseas clients constitute business carried on by a resident outside India. There was a direct nexus between the payments made by the taxpayer to the foreign sub-contractors and the amounts received from the overseas clients. Accordingly, the payments made to the foreign sub-contractors fell outside the ambit of Section 9(1)(vii) of the Income-tax Act, 1961 (the Act), in view of the exception carved out in sub-clause (b) thereto and therefore, not taxable in India.

Facts of the case

- The taxpayer is engaged in the business of production of 2D and 3D animation films for the overseas companies like Walt Disney, Columbia, DIC Animation, etc., (the overseas clients). The taxpayer gets orders from these companies for production of animation films at their requisition of scheduled deliverables.

- During the Financial Years (FYs) 2006-07 and 2007-08, the taxpayer sub-contracted/outsourced some episodes or part of an episode to foreign sub-contractors (i.e. Hong Kong entity and Chinese entity) out of the orders received by it from some of the overseas clients.

- In this regard, the taxpayer entered into an ‘Outsourcing Facilities Agreement’ with foreign sub-contractors. As per the terms of the agreement, the sub-contractor has to provide ‘production work’/‘production material’ to the taxpayer by availing the necessary production premises, facilities, personnel, materials, services and expertise.

1 ADIT v. DQ Entertainment (International) P. Ltd. [ITA Nos. 276 & 277/Hyd/2010 (AY 06-07 & 07-08)] – Taxsutra.com
• The taxpayer claimed that the payments made to these foreign sub-contractors are in the course of business activity and they do not have any business connection or Permanent Establishment (PE) in India. Also, the income did not arise in India under the deeming provisions of Section 9(1)(vii) of the Act. Accordingly, the payments are not taxable in India.

• The Assessing Officer (AO) held that the production material was not available off the shelf with the foreign sub-contractor. The property was created by sub-contractor on request of the taxpayer. So substance of contract is not supply of goods but supply of service. The payments were considered as FTS under Section 9(1)(vii) of the Act and since the taxpayer failed to withhold taxes on such payments, demand under Section 201 and 201(1A) of the Act was raised.

Tribunal’s ruling

The Tribunal upheld the following findings of the CIT(A):

**Taxability as FTS**

- There was no element of any technical services in the production of animation films nor in the production of a part or certain episodes of an animation film. The payments received by the taxpayer from overseas clients for the similar work executed by it were neither subjected to withholding of tax nor was it called upon to file its return by those countries. Had it been otherwise, the taxpayer itself would have suffered withholding of tax in the hands of overseas clients at one point of time or other.

- The Delhi Tribunal in the case of Sheraton International Inc. has observed that job undertaken by one party for the other party for supply of any goods or services may involve utilisation of the knowledge, information and expertise of the party undertaking the said job. However, such utilisation cannot be a reason to treat the services so rendered, of technical or consultancy in nature, making any technology available to other party. Further, this decision was upheld by the Delhi High Court.

**Applicability of exception to Section 9(1)(vii)(b) of the Act**

- Section 9(1)(vii)(b) of the Act provides two categories of income (fees) i.e. (a) in a business carried on by a resident outside India; or (b) for the purpose of making or earning any income from any source outside India. The first category of income doesn't refer to any source, whereas the second category of income refers to any source outside India. Taxpayer’s business with its overseas clients constitutes a business carried on by resident outside India, making the taxpayer to satisfy the first category of income.

- Perusal of the clause of the agreement with overseas client relating to jurisdiction for resolving any dispute between the taxpayer and the overseas client indicated that the jurisdiction of the Courts/arbitration shall be only at such place where the overseas client is located. The contracts are all entered into by the taxpayer outside India making it exposed to the respective foreign law and therefore, as per the governing laws of the foreign countries it has to be viewed that the contract itself is the 'source of income' as per the decision of the Supreme Court in the case of Kunwar Trivikram Narain Singh.

- The actual viewership of the animation films produced and supplied to overseas clients is in fact located outside India. It is only source of income which is located outside India and for earning this income only, it made payments to sub-contractors.

- There is a direct nexus between the payments made by the taxpayer to foreign sub-contractor and the amounts received or receivable from the overseas client. Therefore, it has been held that the provisions of Section 9(1)(vii)(b) of the Act would be applicable to the facts of the present case.

- Reference was made to the Delhi Tribunal ruling in the case of Lufthansa Cargo India (P) Ltd wherein the Delhi Tribunal elaborating the word ‘source’ was stated that it may encompass the payer of income or the activity which gives rise to the income. It was stated that source could not refer to the payer but only to the activity, which resulted in the income. It was explained that the source is the activity which results into the income. If the source of any income is situated in India, then it is irrelevant whether the business carried on by such non-resident is in India or elsewhere.

- Accordingly, there was no liability to deduct tax while making payments to the foreign sub-contractors under Section 195 of the Act. Consequently, the demand raised by the AO under Section 201 of Act was deleted.
Our comments

It is important to note that even under the wider definition of FTS under the Act, the Tribunal has held that just because expertise, knowledge, technology and experience is possessed by the service provider and the same has been utilised for rendering the services, it cannot be said that the services so rendered are in the nature of technical and consultancy services without making any technology available to the other person.

The Tribunal has applied the exception provided under Section 9(1)(vii)(b) of the Act to the extent that such FTS was utilised in a business carried on by the Indian entity outside India or for earning any income from any source outside India. Accordingly, the FTS does not deem to accrue or arise in India in the hands of non-resident.

The Delhi High Court in the case of Havells India Ltd\(^6\) held that for a payment made to a non-resident to fall within the second exception provided in Section 9(1)(vii)(b) of the Act, the source of the income, and not the receipt should be situated outside India. The Tribunal in the present case based on facts of the case has held that taxpayer carried a business outside India and therefore, payment to foreign sub-contractor for production of animation films is not taxable in India.

Thus, the taxpayer would need to specifically demonstrate that the technical services were utilised in a business carried on outside India/to earn from a source outside India, in order to fall under the exception to Section 9(1)(vii)(b) and thereby claim non-taxability of payments made to the non-resident.

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\(^6\) CIT v. Havells India Ltd [2012] 352 ITR 376 (Del)
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