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Friday Tax Alert

Delhi ITAT rules that salary reimbursement for seconded employees is not fee for technical services

Entering into secondment arrangements is a standard practice among multinational enterprises, which involves the temporary move of skilled employees to another organisation for a specific period. While these arrangements may seem commercially straightforward, they are not free from litigation. Typically, in secondment arrangements, salary reimbursement is often made by the Indian entity to the foreign entity, where the home country (foreign entity) payroll is continued during the secondment period. The core dispute is whether the reimbursement of seconded employee costs received by a foreign entity is taxable in India. In this regard, recently, the Delhi ITAT had an opportunity to analyse whether payments made by the Indian entities to the Japanese taxpayer in respect of salaries paid to the seconded employees in Japan are in the nature of reimbursement of the salary for the services rendered in India or are in the nature of Fee for Technical Services (FTS). We have summarised this ruling hereunder:

FACTS OF THE CASE

The taxpayer, a company resident in Japan, is engaged in the manufacturing and marketing of communications systems, electronic components, heavy electrical operators, consumer products, medical diagnostics, imaging equipment, etc. During Fiscal Year (FY) 2019-20, the taxpayer received reimbursements amounting to INR 107.63mn in respect of salary paid in Japan to the seconded employees of various Indian companies. The taxpayer made payment of salaries in Japan on behalf of Indian employer entities owing to administrative convenience. The tax officer treated the said amount as FTS under section 9(1)(vii) of the Income Tax Act, 1961 ("the Act") and Article 12(4) of the India-Japan Double Taxation Avoidance Agreement (DTAA) and made an addition to the income. Aggrieved, the taxpayer preferred an appeal before the Delhi ITAT.

DECISION OF DELHI ITAT

The Delhi ITAT, while ruling in favour of the taxpayer, made the following observations:

- ✓ The Indian entities have made salary payments to the seconded employees only after they entered into a separate agreement/contract of employment.
- ✓ On perusal of the said contract/appointment letter, it shows that the payment of salary to the seconded employees is solely by the Indian company. The salary would be made partly in yen and partly in Indian rupees.
- ✓ The employees were working under the control of the Indian company, and the Indian company had the right to terminate the services of the seconded employee in case of breach of the terms and conditions of employment.
- ✓ Form No. 16 showed that the salary payment to the seconded employees is subject to tax deducted at source (TDS) provisions, and accordingly, taxes were withheld by the Indian companies.
- ✓ Reliance was placed on the Hon'ble Delhi High Court's decision in the case of *PCIT vs. Boeing India (P.) Ltd.* 146 taxmann.com 131 (Delhi) and *Flipkart Internet (P.) Ltd vs. DCIT 139 taxmann.com 595 (Karnataka)* wherein it was held that where the reimbursements are in the nature of salary, the same could not be treated as FTS.
- ✓ The term 'fees for technical services' is defined in Article 12(4) of the India-Japan DTAA to mean 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.
- ✓ Once it is established that the payments are made as salary to the employees for the services rendered in India, such payments are outside the purview of FTS.

Toshiba Corporation v. The Deputy Commissioner of Income Tax (ITA No.2587/DEL/2023)

Supreme Court holds non-compete fee as revenue expenditure for Income-Tax purposes

The issue of the allowability of a non-compete fee as a deductible expenditure has been an area of dispute between the taxpayer and the tax authorities. The tax authorities have often sought to treat the non-compete fee as capital expenditure, often coupled with a denial of depreciation. The Supreme Court has held that payment of non-compete fee does not result in acquisition of a capital asset or alteration of profit-making structure of the business and is allowable as revenue expenditure under section 37(1) of the Act. We have summarised this ruling hereunder:

FACTS OF THE CASE

- ✓ The taxpayer, a company engaged in the business of importing, marketing and selling electronic office products and equipment in India, is a joint venture between Sharp Corporation and Larsen & Toubro Limited (L&T). Sharp Corporation is engaged globally in designing, manufacturing and marketing electronic products, while L&T is engaged in the same business as that of Sharp in India.
- ✓ The taxpayer paid INR 30 mn to L&T as consideration for L&T agreeing not to set up, undertake or assist in any business in India relating to sale, marketing or trading of electronic office products for a period of 7 years. Such amount was claimed as a deductible revenue expenditure in return of income as non-compete fee.
- ✓ The tax officer treated the non-compete fee as capital expenditure on the premise that it resulted in an enduring benefit by eliminating competition. Under normal litigation route, this matter reached the Supreme Court with the key issue being allowability of non-compete fee.

DECISION OF THE SUPREME COURT

The Supreme Court, while holding that non-compete fee is an allowable revenue expenditure under section 37(1) of the IT Act, made following key observations:

- ✓ Non-compete fee from the payer's perspective is paid in anticipation that absence of competition from the other party for specified period or territory secures a benefit in terms of enhancing its profitability. However, there is no certainty that such benefit would accrue, while the payer may still not achieve the desired result, in spite of a non-compete arrangement.
- ✓ Such payments merely facilitate carrying on of business more efficiently and profitably and it neither results in creation of any new asset nor accretion to profit earning apparatus of the payer. The enduring advantage, if any, by restricting a competitor in business, is not in capital field.
- ✓ Duration of competitive restraint is not determinative of nature of expenditure and as long as the advantage is not in capital field and leaves fixed assets untouched, such expenditure, would be an allowable revenue expenditure.
- ✓ Therefore, the non-compete fee paid by taxpayer only kept a potential competitor out of same business, did not eliminate competition or create any monopoly. Hence, did not amount to acquisition of a capital asset or a new profit-earning structure. Accordingly, the non-compete fee paid to L&T is allowable as revenue expenditure under section 37(1) of the Act.

Sharp Business System v. CIT, C.A. No. 4072 of 2014 (Supreme Court)

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