Tax alert: Taxability of partners of firm to be examined under respective tax treaties; legal services are not FTS

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The Delhi Bench of the Income-tax Appellate Tribunal (ITAT) has held that since UK partnership firm is tax transparent, the tax liability of each partner has to be examined with reference to tax treaty with country of respective residence. Further, professional / legal services rendered by law firms are excluded from the definition of Fees for Technical Services (FTS) under India's tax treaty with the UK, Belgium, Japan, Australia etc.

In a nutshell

The income of a partnership firm based in UK is taxed in the hands of the individual partners, depending upon the residential status of each partner of the firm. Therefore, the partners of the UK partnership firm who are not residents of UK, would be subject to tax on their respective share of profits from the partnership firm in the state of their residence. Accordingly, tax treaties of each partner's country of residence had to be examined.

Article 13 of the India-UK tax treaty defines FTS, which specifically excludes payments to individuals or partnership firms for professional services covered under Article 15 such as services rendered by teachers, physicians, surgeons, lawyers, engineers, architects, dentists and accountants. The professional services rendered by above category of specialized professionals are distinct from services that form part of FTS.

Since UK partnership firm is tax transparent, the tax liability of each partner was to be examined with reference to tax treaty with country of their respective residence.

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Background:

- The taxpayer[1] is a firm of solicitors engaged in providing legal services to its clients worldwide, having its registered office in the United Kingdom (UK). The taxpayer rendered services through its members and employees primarily from outside India, with intermittent visits to India. It has partners from the UK and other countries, namely, Australia, France, Belgium, China, Japan and Germany.
- The taxpayer is a fiscally transparent entity under the UK laws. For the purpose of payment of tax, its income/losses were distributed to its partners in their respective profit-sharing ratio (PSR). The partners of the taxpayer based in the UK had PSR to the extent of 82.121%, whereas non-UK partners had share in profit of 17.88% of the revenue earned by the taxpayer from Indian engagements.
- In the return of income, the taxpayer claimed revenue received from provision of legal services on engagements in India as exempt under the provisions of the India-UK tax treaty.

  Further, in respect of income received in India relatable to the profit share of non-UK resident partners, the same was claimed as not taxable in India under the tax treaties between India and the respective countries of tax residence of the non-UK partners.

  In case of partners from Germany, the taxpayer offered to tax receipts to the extent of profit share of partners based in Germany.
- During the course of audit proceedings, the Assessing Officer (AO) held that:
  - so far as the share of profit of the partners resident of the UK was not taxable in India under the India-UK tax treaty.
  - for non-UK resident partners, the profits attributable to such partners were taxable in India as Fees for Technical Services (FTS) under section 9(1)(vii) of the Income Tax Act, 1961 (ITA) [corresponding to section 9(7) of the Income-tax Act, 2025] as the benefit of tax treaty was not available to the taxpayer firm in respect of such non-UK resident partners.
  - for partners from Germany, the same was offered to tax by the taxpayer in terms of the India-Germany tax treaty and thereby accepted.
- Aggrieved, the taxpayer filed appeal before the Commissioner of Income-tax (Appeals) [CIT(A)], which dismissed the taxpayer's appeal and upheld the AO's addition.
- Aggrieved, the taxpayer filed an appeal before the Delhi Bench of the Income-tax Appellate Tribunal (ITAT).

Relevant extract of section 9 of ITA

(1) ***The following incomes shall be deemed to accrue or arise in India :—***

....

(vii) income by way of fees for technical services payable by—

....

For the purposes of this clause, "fees for technical services" means any consideration (including any lump sum consideration) for the rendering of any managerial, technical or consultancy services (including the provision of services of technical or other personnel) *but does not include consideration for any construction, assembly, mining or like project undertaken by the recipient or consideration which would be income of the recipient chargeable under the head "Salaries";*

Relevant provisions of Article 4 of the India-UK tax treaty-Fiscal Domicile

1. For the purposes of this Convention, the term ***"resident of a Contracting State"*** *means any person who,*

[1] Herbert Smith Freehills LLP v CIT(A) (ITA 2281/DEL/2019) [Delhi ITAT]

under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature, provided, however, that:

…

(b) in the case of income derived or paid by a partnership, estate, or trust, this term applies only to the extent that the income derived by such partnership, estate, or trust is subject to tax in that State as the income of a resident, either in its hands or in the hands of its partners or beneficiaries."

Article 13 Royalty and Fees for Technical Services

…

5. The definition of fees for technical services in paragraph 4 of this Article shall not include amounts paid:

…

(e) to an employee of the person making the payments or to any individual or partnership for professional services as defined in Article 15 (Independent personal services) of this Convention.

Article 15 Independent Personal services

…

3. The term "professional services" includes independent, scientific, literary, artistic, educational or teaching activities as well as the independent activities or physicians, surgeons, lawyers, engineers, architects, dentists and accountants.

Decision of the ITAT:

The ITAT acknowledged that the issue for consideration was with respect to taxability of receipts in hands of the taxpayer to the extent attributable to non-UK based partners of the taxpayer firm.

The ITAT noted as follows:

Taxability of income of partnership firms or Limited Liability Partnerships (LLPs) in the UK

- Partnership firms or LLPs in the UK are 'tax transparent'. Each member of the partnership firm is assessed to tax on his share of the partnership income or gains. Though there is an obligation on partnership firm to file tax return, there is no tax liability on the partnership firm. Any non-UK source profits or gains made by a partnership firm are subject to tax in the UK in hands of the partners resident in the UK.
- There is no restriction on non-residents of the UK or nationals of other countries becoming partners in a partnership firm based in the UK. The share of profit of non-UK partners in the partnership firm is not subject to taxation in the UK. UK based partnership firm being tax transparent, non-UK resident partners cannot avail benefit of the India-UK tax treaty.

Taxability of firm under India-UK tax treaty

- The India-UK tax treaty defines the term 'person', which, *inter alia*, includes a 'body of persons'. Thus, a partnership firm is included within the meaning of the term 'person'.

  As per Article 4(1)(b) of the India-UK tax treaty, any person who is a resident of the UK is liable to tax in the UK by reason of his domicile, residence, place of management, place of incorporation or any other criteria of a similar nature. Since, partnership firms are tax transparent, the treaty benefit was extended to partnership firms to the extent of income of partnership firm attributable to its partners in the UK.
- Thus, the income of a partnership firm is taxable in the state of residence only to the extent of income derived by the partners in proportion to their share in the profits of the firm.

  The income of a partnership firm based in UK is taxed in the hands of the individual partners depending upon the residential status of each partner of the firm. Therefore, the partners of the UK partnership firm who are not residents of UK would be subject to tax on their respective share of profits from partnership firm in the state of their residence.

Accordingly, tax treaties of each partner's country of residence had to be examined.

- The AO had accepted that:
  - The share of profit of partners based in the UK was not taxable in India under the India-UK tax treaty.
  - The income offered by the taxpayer to tax is with regard to the partners of the firm based in Germany under the India-Germany tax treaty.

  Thus, the AO himself had accepted that taxability of each partner of the partnership firm was to be determined on the basis of partner's state of residence.

Legal services whether taxable as FTS under ITA?

- As per an earlier ruling[2] of the Delhi Bench of the ITAT, the ITAT had held that payments to non-resident foreign law firms for professional services do not fall within the meaning of FTS under section 9(1)(vii) of the ITA. Reference was made to section 194J of the ITA [relating to TDS on professional services].

  Similar view was taken in another ITAT ruling[3],wherein the ITAT held that payments for providing legal/professional services to non-residents were distinct from FTS as defined under section 9(1)(vii) of the ITA and the payments made to non-resident attorneys were not in the nature of FTS.

Taxability of legal services under the India-UK tax treaty

- Article 13 of the India-UK tax treaty defines 'FTS'. The definition specifically excludes payments to individuals or partnership firms for professional services covered under Article 15 such as services rendered by teachers, physicians, surgeons, layers, engineers, architects, dentists and accountants.

  The professional services rendered by above category of specialized professionals are distinct from services that form part of FTS. Similar professional services are excluded from the preview of FTS/Royalty in India's tax treaties with other countries viz. Belgium, Japan, Australia, etc.

- Hence, the services which are in the nature of professional services, have been excluded from FTS. Ergo, the professional/legal services rendered by law firms do not fall within the meaning of FTS. Based on Article 13 of India-UK tax treaty and earlier ITAT rulings, the payments made to the taxpayer for Indian engagements could not be brought under the definition of FTS under section 9(1)(vii) of the ITA.

Since UK partnership firm is tax transparent, the tax liability in the hand of each partner had to be examined. In view of the above, the ITAT restored the issue back to the AO to examine tax liability of non-UK resident partners of the taxpayer firm with reference to the tax treaty of the country of which they were resident.

Comments:

The tax treatment of fiscally transparent entities under respective tax treaties has been a subject matter of litigation. In the context of the India–UK tax treaty, issues relating to the taxation of partnership firms, the allocation of income to partners, and the distinction between FTS and professional services, continue to be subjects of interpretational significance. An analysis of these concepts is essential to understanding the scope of treaty protection and the corresponding tax implications under a tax treaty framework.

The ITAT in this ruling has, *inter-alia*, held as follows:

- The income of a partnership firm based in UK is taxed in the hands of the individual partners depending

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[2] ACIT vs. Subramaniam Hariharan [2025] 177 taxmann.com 640 (Delhi - Trib.)

[3] Chander Mohan Lall vs. Assistant Commissioner of Income-tax [2022] 134 taxmann.com 292 (Delhi-Trib.)

upon the residential status of each partner of the firm. Therefore, the partners of the UK partnership firm who are not residents of UK would be subject to tax on their respective share of profits from partnership firm in the state of their residence. Accordingly, tax treaties of each partner's country of residence had to be examined.

- Article 13 of the India-UK tax treaty defines FTS, which specifically excludes payments to individuals or partnership firms for professional services covered under Article 15 such as services rendered by teachers, physicians, surgeons, layers, engineers, architects, dentists and accountants. The professional services rendered by above category of specialized professionals are distinct from services that form part of FTS.

  Since UK partnership firm is tax transparent, the tax liability in the hand of each partner was to be examined with reference to tax treaty with country of their respective residence.

In case of an earlier ITAT ruling[4], it was held that taxpayer was eligible for the benefits of India-UK tax treaty so long as entire profits of the partnership firm were taxed in UK, whether the taxable income was determined in relation to personal characteristics of the partners or in the hands of the firm directly.

Also, in another earlier ITAT ruling[5], it was held that the fees received from provision of legal consultancy services was income accruing from business connection in India under section 9(1)(*i*) [Section 9(2) of the Income-tax Act, 2025] and Article 15 and not fees for technical services under section 9(1)(*vii*) [Section 9(7) of the Income-tax Act, 2025] and Article 7 of the India-UK tax treaty.

Taxpayers may want to evaluate the impact of this ruling to the specific facts of their cases.

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[4] Linklaters LLP vs. Deputy Commissioner of Income-tax [2023] 150 taxmann.com 222 (Mumbai - Trib.)[11-05-2023]

[5] Assistant Director of Income-tax (IT) -1(2) vs. Clifford Chance [2013] 33 taxmann.com 200 (Mumbai) (SB)