Services provided by a foreign entity outside India is not taxable under the Income-tax Act

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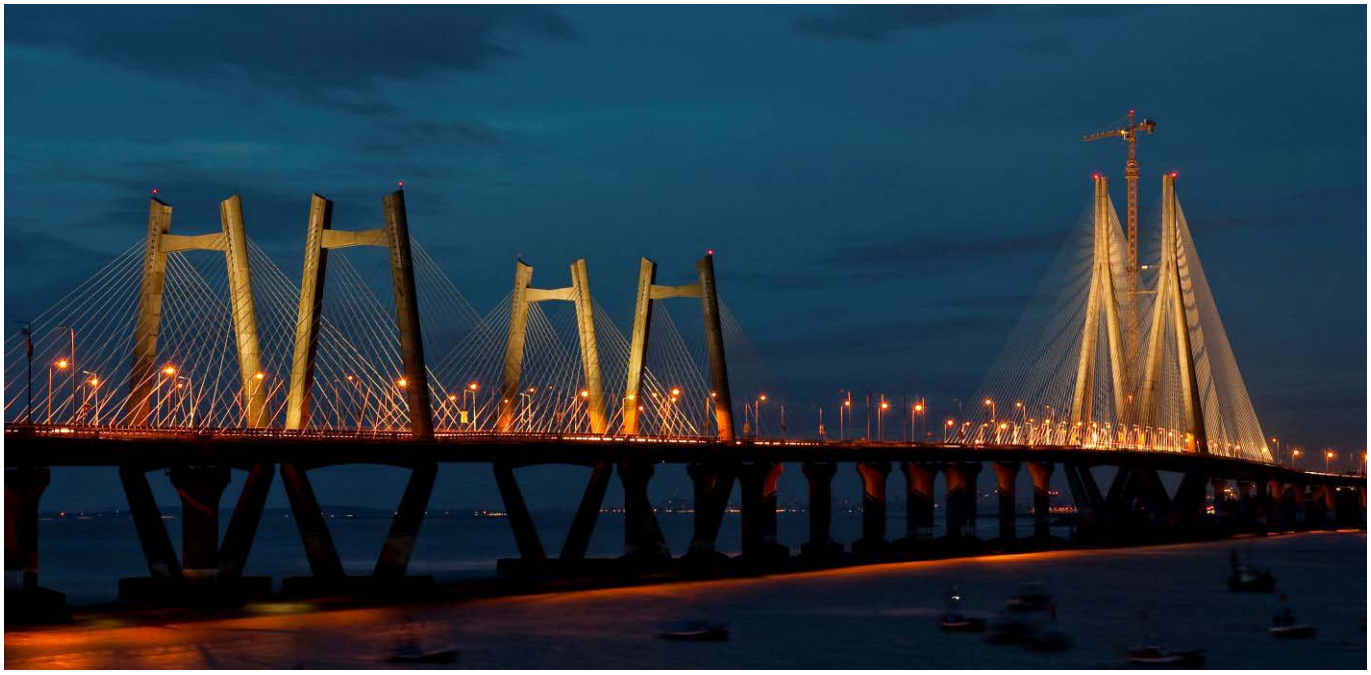

Background

Recently, the Special Bench of the Mumbai Income-tax Appellate Tribunal, in the case of Clifford Chance[1] (the taxpayer) held that services provided by the taxpayer outside India were not taxable under Income-tax Act, 1961 (the Act).

Further the Special Bench of the Tribunal held that there is no need to refer to the provisions of Article 7(1) of UN Model Convention which are materially different from the provisions of Article 7(1) of the India-UK tax treaty read with Article 7(3) thereof. Accordingly, the Special Bench Tribunal rejected the application of force of attraction rule while applying the India-UK tax treaty.

Facts of the case

- The taxpayer is a firm of Solicitors operating as a partnership with its principal office in UK. It was engaged in providing international legal services in certain areas. The taxpayer did not have an office or fixed base in India. During the year under consideration, the taxpayer rendered legal consultancy services in connection with different projects in India. It did not have any office in India, but some part of the work was performed by its employees and partners during their visits to India.

- The taxpayer relied upon Article 15 of the India-UK tax treaty (which deals with Independent Personal Services) and claimed that aggregate period or periods of stay of its partners and employees during the years did not exceed 90 days in India. Accordingly, it was submitted that the income was not taxable in India.In relation to the Assessment Year (AY) 1998-99, the income attributable to services rendered in India was offered to tax by the taxpayer.

- The Assessing Officer (AO) however rejected the relief under Article 15 of the tax treaty to the firm and also concluded that the taxpayer had created a PE in India. The AO held that the profits of the taxpayer to the extent they are directly or indirectly attributable to PE in India, were taxable in India, as per Article 7 of the India-UK tax treaty.

[1] ADIT v. Clifford Chance [ITA Nos. 5034/Mum/2004, 5035/Mum/2004, 7095/Mum/2004, 3021/Mum/2005] – Taxsutra.com

- The Commissioner of Income-tax CIT(A) upheld the benefit under Article 15 to the taxpayer, by relying on Tribunal's order in the taxpayer's own case[2] for AY 1996-97 and since the stay in India of the employees/partners was less than 90 days. In the year where the stay exceeded 90 days, the CIT(A) again relied on the Tribunal's ruling and held that only income attributable to services rendered in India was subject to tax in India and the income attributable to services rendered outside India was not taxable.

Retrospective amendment to Section 9 of the Act

- During the course of Appeal proceeding before in the taxpayer's case, in relation to the AY 1996-97 and 1997-98, the Bombay High Court on 19 December 2008, in taxpayer's earlier case[3] involving similar issue, relied on Supreme Court's decision in the case of Ishikawajima Harima Heavy Industries Ltd.[4] and held that a non-resident is taxable on income for services only if the services are rendered within India and are part of a business or profession carried on by such person in India. Both the above conditions have to be satisfied simultaneously.

- Subsequently, the Explanation to Section 9 of the Act was amended by Finance Act 2010 with retrospective effect from 1 June 1976 whereby the income of a non-resident shall be deemed to accrue or arise in India under Section 9(1)(v), (vi) and (vii) of the Income-tax Act, 1961 (the Act) , whether or not, the non-resident has rendered services in India.

- In Linklaters LLP[5], The Mumbai Tribunal had held that Bombay High Court's ruling in Clifford Chance and Supreme Court ruling in Ishikawajima Harima Heavy Industries Ltd were no longer good law in view of retrospective amendment made to Section 9(1) later by the Finance Act, 2010. However, the division bench of the Tribunal in the taxpayer' present case was of the opinion that in view of the fact the income of the taxpayer is taxable under Section 9(1)(i) of the Act, therefore, the amendment by the Finance Act, 2010 by way of insertion of Explanation to Section 9(1)(v), (vi) and (vii) of the Act does not affect the taxpayer.

- Therefore, in view of contrary judgment between two divisional benches, the Tribunal referred the matter to the Special Bench to decide whether insertion of Explanation to Section 9 by way of amendment by Finance Act, 2010 with retrospective effect from 1 June 1976, changes the position of law, as far as the taxpayer is concerned.

- The Special Bench of the Tribunal held that the amendment made by the Finance Act 2010 in Section 9 of the Act with retrospective effect from 1 June 1976 is applicable only in the cases covered under Section 9(1)(v), (vi) and (vii) of the Act. Therefore, such amendment does not negate the decision of the Bombay High Court in the taxpayer's earlier case for AY 1996-97 and the said decision rendered in the context of Section 9(1)(i) still holds good even after the amendment in so far as the taxpayer's case is concerned. Accordingly, services provided by the taxpayer outside India were not taxable in India.

Force of Attraction

- The second issue under consideration before the Tribunal was whether the entire income from the Indian projects would be taxable in India or only as much as is held attributable to the services rendered in India.

- The Tribunal in the case of Airlines Rotables Limited[6] and Set Satellite (Singapore) (Pte) Ltd.[7] held that the existence of PE in a country cannot warrant or justify taxation of all the profits arising to a foreign enterprise in that country. Even if there is a PE, one cannot infer application of the force of attraction principle and proceed to bring to tax all the profits of the foreign enterprise whether or not they relate to the PE.

- However, the Tribunal in the case of Linklaters LLP by applying 'force of attraction' principle, observed that fees for services rendered in India as well as for services rendered from outside India for projects in India were taxable in India.

- Therefore, in view of above contrary decisions the Tribunal referred the matter to the Special Bench of the Tribunal to decide the second question i.e. whether the consideration attributable to the services rendered in the State of Residence is taxable in the Source State based on the interpretation of the term 'directly or indirectly attributable to PE' in Article 7(1) of the tax treaty.

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[2] Clifford Chance v. DIT [ITA No. 1327 (Mum) of 2001]
[3] Clifford Chance v. DIT [2009] 176 Taxman 485 (Bom)
[4] Ishikawajima Harima Heavy Industries Ltd. v. DIT [2007] 288 ITR 408 (SC)
[5] Linklaters LLP v. ITO [2010] 40 SOT 51 (Mum
[6] Airlines Rotables Limited v. JDIT [2010] 131 TTJ 385 (Mum)
[7] DDIT v. Set Satellite (Singapore) (Pte) Ltd. [106 ITD 175] (Mum)

- The Special Bench of the Tribunal on a perusal of Article 7(1) of the India-UK tax treaty read with Article 7(3), held that the provisions thereof are not at all akin to the provisions of Section 7(1)(b) and 7(1)(c) of the UN Model Convention. When the connotations of 'profits indirectly attributable to permanent establishment' are defined specifically in Article 7(3) of the India-UK tax treaty which clearly explains the scope and ambit of the profits indirectly attributable to the PE and the provisions of said article being unambiguous and capable of giving a definite meaning, there is really no need to refer to the provisions of Article 7(1) of UN Model Convention which are materially different from the provisions of Article 7(1) of the India-UK tax treaty read with Article 7(3) thereof.

- The reliance of the Division Bench of this Tribunal on the provisions of Article 7(1)(b) and 7(1)(c) of the UN Model Convention as well as on the UN Model Convention Commentary to come to a conclusion in the case of Linklaters LLP is misplaced. Further the connotations of 'profits indirectly attributable to permanent establishment' used in Article 7(1) of the India-UK tax treaty incorporates a force of attraction rule thereby bringing an enterprise having a PE in another country within the fiscal jurisdiction of that another country to such a degree that such another country can properly tax all profits that the enterprise derives from that country whether the transactions are routed and performed through their PE or not is clearly misplaced. Accordingly, the Special Bench Tribunal rejected the application of force of attraction rule while applying the India-UK tax treaty.

Our comments

This is a welcome ruling of the Special Bench of the Mumbai Tribunal dealing with issue of taxability of services rendered outside India. The Special Bench held that services provided by a foreign entity outside India is not taxable under the Act inspite of retrospective amendment to Section 9 of the Act.

On the issue of applicability of 'force of attraction' principles, the Special Bench held that the provisions under the UN Model Conventions are different than the provisions of Article 7(1) read with Article 7(3) of the India-UK tax treaty. Article 7(3) of India-UK tax treaty clearly explains the scope and ambit of the profits indirectly attributable to the PE. Accordingly, force of attraction principle would not be applicable to India-UK tax treaty.

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