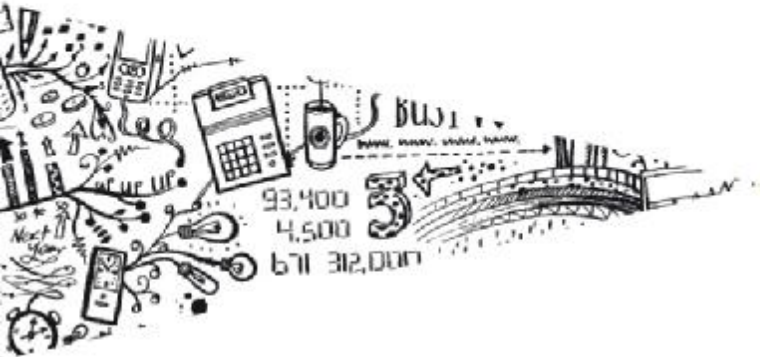


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EY Tax Alert

Mumbai Tribunal rules on source rule for fees for technical services



Executive summary

This Tax Alert summarizes a recent ruling of the Mumbai Income Tax Appellate Tribunal (Tribunal) in the case of M/s Bajaj Hindustan Ltd. (Taxpayer) [ITA No. 63/MUM/09 (2007-08)] on the issue of whether fees for technical services (FTS) paid to a non-resident (NR) company in relation to assistance for proposed expansion of the Taxpayer's business outside India, would be taxable under the Indian Tax Laws (ITL). The Tribunal noted that the Taxpayer had paid FTS for creating a source of income outside India which had not yet come into existence. The Tribunal held that, having regard to specific source rule of the ITL, FTS paid to an NR for earning income from a source outside India is not taxable in India and this provision is wide enough to cover any future source of income. Hence, payments made by the Taxpayer to an NR company for the proposed business expansion were not taxable in India under the ITL.

Background and facts

- ▶ Source rule: Section 9(1)(vii)(b) of the ITL provides that FTS paid to an NR would be taxable in India where the same is payable by a resident of India, subject to two exceptions. The payment of FTS is not taxable in India where the services are utilized:
 - (i) In a business or profession carried out by such resident outside India (first exception)
 - (ii) For the purpose of making or earning any income from any source outside India (second exception)
- ▶ The Taxpayer, a resident of India, was engaged in the business of manufacturing of sugar and it wanted to acquire sugar mills/distillery plants in Brazil for expansion of its business operations. For this purpose, it engaged the services of a financial advisor in Brazil (NR Company) to assist and advise in the proposed transaction. Payments were made to the NR Company for the services provided during the relevant tax year. The agreement between the Taxpayer and the NR Company was in the form of a proposal to study the possibility of expanding the Taxpayer's operations in Brazil.
- ▶ The Taxpayer was of the view that the payments were not taxable in India as they fell within the exceptions to the source rule of the ITL. The Tax Authority sought to tax the above payments as FTS taxable in India and treated the Taxpayer as a defaulter for not withholding appropriate taxes under the ITL.
- ▶ Before the first appellate authority, the Taxpayer submitted that it had incorporated a subsidiary in Brazil to acquire the sugar mills/distillery plants. Hence, the services of the NR Company would be utilized in the business which would be carried out outside India through the Taxpayer's subsidiary and the income derived from the said sugar mills/distillery plants would qualify as income from a source outside India. The first appellate authority ruled in favor of the Taxpayer.
- ▶ Aggrieved by the above, the Tax Authority preferred an appeal before the Tribunal. Before the Tribunal, the Tax Authority contended that:
 - ▶ The Taxpayer was utilizing the services of the NR Company in respect of a business or profession carried on by the Taxpayer in India.
 - ▶ The second exception contemplated in the source rule is only in respect of an existing source of income. The payment in question was for the purpose of earning income from a source outside India which had not come into the existence and the Taxpayer only proposed to create the source of earning income outside India in future.

Tribunal's ruling

- ▶ Payments made by the Taxpayer for the services rendered by the NR Company fall within the meaning of FTS under the ITL. The issue is with regard to taxability of such payments under the source rule of the ITL, determining taxability of FTS in India.
- ▶ The Taxpayer carried on business in India and had utilized the services of the NR Company in connection with such business. Therefore, the case of the Taxpayer would not fall within the first exception of the source rule, notwithstanding the fact that services were rendered only in Brazil.
- ▶ The Taxpayer wanted to acquire sugar mills/distillery plants in Brazil and, for that purpose, had set up a subsidiary company in Brazil. Thus, the Taxpayer was contemplating creation of a source for earning income outside India. It is, no doubt, true that the source of income had not come into existence.
- ▶ There is nothing in the language of the second exception of the source rule which would show

that the same is restricted to an existing source of income only or that the source of income should have come into existence so as to except the payment of FTS from taxability under the ITL.

- ▶ The payments made by the Taxpayer to the NR Company for creating a future source of income would fall within the second exception of the source rule for FTS and, hence, not taxable in India.

Comments

This Tribunal ruling gives a significant interpretation of the source rule for FTS under the ITL so as to exclude FTS paid by a resident for the purpose of creating a future source of income outside India. This ruling would be beneficial to many taxpayers in India which are contemplating extension of their business operations outside India. It is pertinent to note that similar language is used in the source rule for interest and royalty under the ITL and the principles laid down in this ruling may be relevant to the above as well. Furthermore, the exceptions in the source rule of the ITL make it relatively narrower as compared to the source rule of tax treaties. This highlights the significance of this Tribunal ruling even in the context of a situation where the recipient of income is from a jurisdiction with which India has a tax treaty.

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