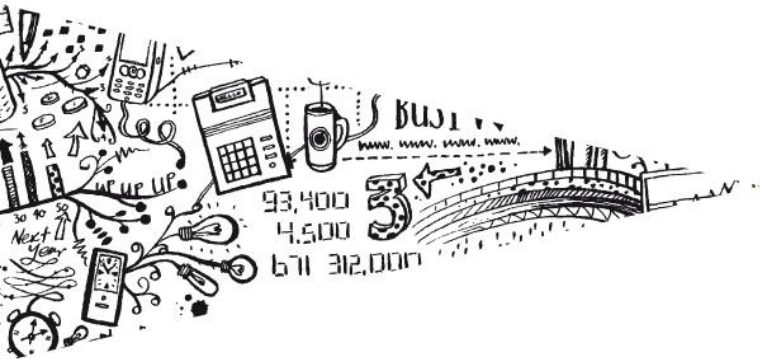


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# EY Tax Alert

Delhi HC rules on FTS and deductibility of expenses arising from a PE



## Executive summary

This Tax Alert summarizes a recent ruling of the Delhi High Court (HC) in the case of Rio Tinto Technical Services<sup>[1]</sup> (Taxpayer) on the issue of taxability of fees received by the Taxpayer for providing services in relation to extraction of coal and iron ore in India through its project office in India, which constitutes a permanent establishment (PE) under the India-Australia Double Taxation Avoidance Agreement (DTAA). The HC held that the income of the Taxpayer would qualify as 'fees for technical services' (FTS) but, since it is connected to a PE, the same would be taxable as 'business income' under the provisions of the DTAA and the Indian Tax Laws (ITL). In view of the specific provision in the ITL, such income would be taxable without deduction of expenses. As a consequence, entire income would be taxable on gross basis at the rate applicable to taxation of FTS.

<sup>[1]</sup> [ITA Nos. 486, 491, 492 of 2011].

## Background and facts

- ▶ The Taxpayer, an Australian company, entered into an agreement for provision of services in India to its affiliates engaged in mining in India. These services included evaluation of coal and iron ore and preparation of a feasibility study report for its affiliates. This included:
  - ▶ Furnishing information with regard to ore body, metallurgical characteristics and infrastructure requirements by bulk sampling and drilling program.
  - ▶ Furnishing information with regard to environment assessment, workability issues, preliminary mining plan and other major options for further study.
  - ▶ Estimation of costs and financial analysis.

The Taxpayer operated through a project office set up in India.

- ▶ Under the ITL, Section 44D provides for taxation of income received from the Government of India or any Indian concern in the form of royalty/FTS, as defined under the ITL, at a reduced rate<sup>[2]</sup>, without granting deduction of expenses. For this purpose, FTS is defined under Section 9(1)(vii) to mean any consideration for rendering managerial, technical or consulting services but does not include consideration for any construction, assembly, mining or like project.

<sup>[2]</sup> As of now such rate is 20% under Section 115A of the ITL.

- ▶ Under the DTAA, Article 7 provides for attribution of profits to a PE as if it were a distinct and separate enterprise and while computing such business profits, deduction of expenses incurred for the purposes of business of the PE would be allowed, subject to and in accordance with the domestic tax laws of the country in which the PE is situated. Furthermore, Article 12 provides for taxation of royalties which include technical/consultancy services related to it.
- ▶ The Taxpayer was of the view that its project office constituted a PE under the DTAA and business profits in connection with the PE are required to be computed by allowing deduction of expenses under Article 7 of the DTAA. The restrictive provisions of Section 44D, prohibiting grant of deduction of expenses, should be read as an option available to taxpayers to pay tax at reduced rate on gross basis and not as a mandatory provision.
- ▶ The Tax Authority disallowed the claim for deduction of expenses under the ITL and taxed the gross receipts at the reduced rate under Section 44D. The First Appellate Authority rejected the appeal of the Taxpayer.
- ▶ The Second Appellate Authority ruled in favor of the Taxpayer and held as follows:
  - ▶ The Taxpayer had a PE in India and it had opted to be taxed as per the beneficial provisions of the DTAA.
  - ▶ For computation of business profits of the PE, the Taxpayer was entitled for deduction of all expenses of the PE.

- ▶ The activities of the Taxpayer were carried on under inclusive and composite contracts and the same were not of purely technical nature. Income from such activities would neither qualify as FTS under the ITL nor as 'royalty' under the DTAA.
- ▶ Since the income was not FTS, the restrictive provisions of Section 44D would not apply.
- ▶ Aggrieved by the above, the Tax Authority preferred an appeal before the HC.

## Issues before the HC

- ▶ Whether activities carried on by the Taxpayer would be taxed as FTS in terms of Article 12 of the DTAA.
- ▶ Whether income earned from rendering services and arising from a PE is to be construed as business income under Article 7 of the DTAA.
- ▶ Whether provisions of Section 44D do not apply and deduction of expenses is allowed in computing the income chargeable to tax in India.

## HC's ruling

### *Taxability under the DTAA*

- ▶ It is not disputed that the Taxpayer had a PE in India. Under the DTAA, any royalty/FTS arising through a PE in India is taxed as business profits and not in terms of Article 12. Hence, Article 7 would apply while computing income of the Taxpayer.

- ▶ For computation of income under Article 7(3) of the DTAA, expenses incurred in earning business income can be claimed as a deduction but only in accordance with and subject to limitations of the ITL. The second part of the above clause of Article 7 allows for claim of deduction of expenses, including administrative and general expenses incurred in India or outside. On a harmonious reading of the two parts of Article 7(3), deduction in respect of expenses must be allowed under the ITL and this requirement is not restricted merely to expenses incurred in India but also to executive and general administrative expenses incurred outside India. The provisions of the DTAA would override any stipulation in the ITL, which may seek to disallow such expenses as are incurred outside India but, otherwise, limitation/restriction of the ITL would need to be considered in granting deduction in respect of such expenses.

### *Computation of business income under the ITL*

- ▶ Under the ITL, business income is computed under the chapter titled 'profits and gains from business or profession' which includes Section 44D providing for computing income from royalty/FTS without deduction of expenses. Section 44D starts with a non-obstante expression overriding the other provisions of the chapter which provide for deduction of expenses under the ITL.
- ▶ For the application of Section 44D, income should be in the nature of FTS as defined under Section 9(1)(vii) of the ITL. The Second Appellate Authority has erred in holding that income from a composite contract would not be in the nature of

FTS. In case of a composite contract, a bifurcation already made in the contract would need to be accepted and, accordingly, income would be taxed. In the absence of a bifurcation in the contract, an estimated allocation would need to be made for tax purposes.

- ▶ The fees received in this case pertain to furnishing of an evaluation report and furnishing technical information as a result of knowledge, experience or expertise gained through a series of tests, mapping, studies, drilling etc. Such fees from furnishing of information would not be composite income so as to be regarded as income from a project and, hence, not FTS under the ITL. In the present case, the fees were paid to acquire technical and managerial information.
- ▶ FTS under Section 9(1)(vii) excludes consideration received for any construction, mining, assembly or like project. Under a narrow interpretation, construction, assembly or mining activities may not strictly fall within and be regarded as the manufacturing or trading activity. To avoid such narrow import and for removal of doubts, the legislature has clarified that construction, assembly or mining projects are not regarded as services relating to FTS.
- ▶ The use of the word 'project' for determining exclusion from FTS is relevant and significant. Such usage mandates that there should be a construction project, an assembly project or a mining project or a like project undertaken by the recipient and the consideration paid should be on the said account. In the present case, it is apparent that the clauses of the agreement do not

disclose that the Taxpayer had undertaken any mining project or a construction project.

- ▶ Constitutional validity of Section 44D was not challenged before the HC and, hence, the same was not examined. The Supreme Court<sup>[3]</sup> had drawn a distinction between non-resident and resident taxpayers as far as gross basis of taxation was concerned. Section 44D provides for lower rate of taxation on gross income (without deduction of expenses) as compared to much higher normal rates of taxes. Hence, Section 44D may work to the advantage of some taxpayers and the disadvantage of others.

## Comments

The HC has acknowledged that while computing business profits under the DTAA, all relevant provisions and restrictions under the ITL need to be taken into account. The ruling also provides guidance on interpretation of the scope and definition of FTS under the ITL in terms of 'composite contracts' and services in relation to construction/mining projects. It may be noted that Section 44D relates to royalty/FTS received from Government of India or an Indian concern in pursuance to an agreement made before 1 April 2003. In relation to royalty/FTS received from Government of India or an Indian concern in pursuance to agreement made on or after 1 April 2003, the ITL has been amended to provide for net basis of taxation at higher rates.

<sup>[3]</sup>A Sanyasi Rao [219 ITR 330]

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