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# EY Tax Alert

Mumbai ITAT explains `business connection' and attribution of profits under India's domestic tax laws



## Executive summary

This Tax Alert summarizes a recent decision of the Mumbai Income Tax Appellate Tribunal (ITAT) in the case of Star Cruise India Travel Services Pvt. Ltd. (Taxpayer). The issue before the ITAT was whether marketing and promotional services provided by the Taxpayer under an agency relationship with a foreign enterprise (FE) constituted a 'business connection' for the FE, resulting in a tax liability for the FE under the provisions of the Indian Tax Laws (ITL). Having regard to the facts of the case, the ITAT upheld the order of the first appellate authority that the Taxpayer's activities were insufficient to constitute a 'business connection' for the FE. Consequently, the Taxpayer was not required to withhold any taxes on its payments to the FE, since its liability was only a vicarious one. The ITAT also observed that, whether a sales agent constitutes a 'business connection' or not would be an academic exercise unless the arm's length nature of the agent's compensation is under challenge. The ITAT has, however, sought to underplay the precedence value of this observation, given the factual matrix of the case.

## Background and facts

- ▶ Under the ITL, a non-resident (NR) is taxable in India if income is either received in India or accrues or arises in India or is deemed to accrue or arise in India. The ITL, furthermore, defines the circumstances in which income is deemed to accrue or arise in India in the hands of an NR. The categories of deemed accrual, inter alia, cover

income accruing directly or indirectly through or from any 'business connection' in India.

- ▶ By way of an explanation, it is stated in the ITL that, in case of a business of which all operations are not carried out in India, the NR will be subject to tax in India only on such part of income as is reasonably attributed to the operations carried out in India. A similar explanation exists even where business is carried on in India through an agent. In such cases, only so much of income as is attributable to the operations carried out in India is deemed to accrue or arise in India.
- ▶ Star Cruise Management Ltd. (SCML), a company incorporated in Isle of Man, provided sales, marketing, and promotional services for the cruise vessels owned, managed, operated or chartered through the Star Cruise group of companies.
- ▶ SCML appointed the Taxpayer, an Indian company, as its canvasser in India, mainly to canvass business for its operations and market its cruise packages and shore excursions. The Taxpayer was also required to advise SCML on relevant laws and regulations, operating criteria relating to sale of tickets, remit collections to SCML etc. As per the arrangement, the Taxpayer was paid 3% of the net cruise charges as remuneration for its services. The Taxpayer did not withhold any taxes on its remittances on sale of tickets, bookings etc., to SCML.
- ▶ The Tax Authority was of the view that the arrangement between the Taxpayer and SCML constituted a 'business connection' for SCML in

India and this was sufficient to invoke tax liability for SCML under the deeming provisions of the ITL. Reliance was placed on the decision of the Authority for Advance Rulings (AAR) in the case of Rajiv Malhotra<sup>[1]</sup> wherein the issue was whether an NR agent engaged in organizing exhibitions in India for promoting products was said to have a 'business connection' in India. The AAR, on facts, held that a 'business connection', as envisaged under the ITL existed in India.

- ▶ Since the Taxpayer failed to withhold appropriate taxes under the ITL on its remittances to SCML, the Taxpayer was treated as a taxpayer-in-default. For this purpose, the Tax Authority quantified 5% of the net cruise charges as income taxable in India in the hands of SCML, on which the Taxpayer was required to withhold taxes.
- ▶ The first appellate authority held that the services rendered, as stipulated under the arrangement, were generic in nature and could not be characterized as 'business connection' as envisaged under the provisions of the ITL. Accordingly, SCML had no tax liability in India and, consequently, the Taxpayer was not liable to be treated as a taxpayer-in-default for not withholding taxes.
- ▶ Aggrieved, the Tax Authority appealed before the ITAT.

<sup>[1]</sup> [284 ITR 564]

## ITAT's ruling

- ▶ The source rule of taxation, which typically originates in domestic tax laws, is based on the principle that an income earned in a tax jurisdiction, irrespective of the residential status of the person earning the income, is liable to be taxed in the tax jurisdiction where the income is earned. Therefore, a tax object i.e., the income which is to be taxed, as a rule, attracts taxability in the source jurisdiction.
- ▶ On the face of it, the application of the source rule in the ITL seems to go little beyond this universally accepted international tax norm. The source rule embedded in the ITL covers not only any income of a person, de hors his residential status, which accrues or arises in India, but also such income which is 'deemed' to accrue and arise in India. In effect, it would seem that, as long as an income has 'business connection' in India, no matter in which part of the world it accrues or arises, it can still be charged to tax in India.
- ▶ However, while the main provision of the deeming fiction seems to take a rather aggressive view of the source rule, the explanations appended to the said provision considerably narrows down the scope of taxability. Thus, the deeming provision restricts taxability of an NR to the extent of income attributable to operations carried out in India, either by the NR or an agent, on behalf of the NR.
- ▶ Whatever be the operations that an agent carries out for the NR, the taxpayer, as an agent, is paid an arm's length compensation for the services rendered. This aspect is not in challenge. Thus, in a case where an agent of the NR, which constitutes a 'business connection', has already been compensated for the services rendered/operations carried out for the NR in India, there cannot be any further income of the NR which can be brought to tax under the deeming provisions of the ITL. Therefore, whether a sales agent, by whatever name called, constitutes a 'business connection' or not is a wholly academic question; unless the very fact of such an agent, having been compensated fairly or at an arm's length for the work done for the NR, is under challenge. However, given the facts and context of this case, the ITAT mentioned that its observations on attribution are academic and should not be treated as having precedent value.
- ▶ The Supreme Court (SC), in the case of R. D. Aggarwal<sup>[2]</sup>, marks a paradigm shift in judicial perceptions about the concept of 'business connection', even though rendered in the context of the earlier Indian Income Tax Act, 1922 (1922 Act). The SC held that the expression 'business connection' postulates a real and intimate relation between trading activity carried on outside the taxable territories and trading activity within the territories, the relation between the two contributing to the earning of income by the NR in its trading activity. This suggests a greater

nexus. Thus, in essence, the SC has held that 'business connection' does not cover, in its scope, mere canvassing for business by an agent in India, as is the case in the present situation, even under the wide provisions of the 1922 Act.

- ▶ The decision of the AAR in the case of Rajiv Malhotra (*supra*) did not have the benefit of examining the impact of the explanation which specifically excluded taxability of income earned from operations carried out outside India. Also, the AAR decision has a limited binding force.
- ▶ As the Taxpayer's liability to withhold taxes is only a vicarious liability, once a conclusion is reached that SCML did not have any principal tax liability in India, the impugned vicarious tax withholding liability of the Taxpayer must also be held to be not good in law. The first appellate authority was, therefore, justified in deleting the same.

## Comments

The ITL recognizes the concept of 'business connection', which is akin to the concept of permanent establishment (PE) under Tax Treaty laws, though perceived to be much wider in its scope and application. The present ruling elucidates the concept of 'business connection' under the ITL. It reiterates that an NR earning income in India can be taxed only to the extent of operations carried out in India. This ruling suggests that the explanation appended to the deeming fiction, in actual, has considerably narrowed down the scope of the provision. This decision should be helpful for taxpayers in applying the concept of

<sup>[2]</sup> [56 ITR 20]

'business connection' and, consequently, determining an NR's tax liability pursuant to its operations in India. The observations in this ruling which, according to the ITAT, should not have a precedent value, nevertheless, recognizes a key principle that, as long as the agent who constitutes a 'business connection' is compensated fairly or on an arm's length basis for operations carried out in India, there could be no tax liability on an FE. The observation highlights the relevance of transfer pricing in appropriately managing a taxable presence exposure likely to arise for an FE by way of a 'business connection' or a PE.

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