Budget 2010-11: Non-resident services outside India : Taxed retroactively

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The Budget has proposed a fundamental change to India's source rules governing non-resident income in the nature of royalties, interest and fees for technical services. As a consequence, a non-resident may now be taxed on such income, even if it has not rendered any services within India, or does not have a residence, place of business or business connection in India.

To understand the impact of this proposal, one can consider a standard EPC or turnkey arrangement, where a non-resident contracts with an Indian person to provide a comprehensive set of services in relation to an Indian project. The scope of services comprises of both, offshore components such as preparation of designs and procurement of equipment as well as onshore components such as installation, commissioning and testing services. It would be logical to conclude that India would not have the right to tax services provided by non-residents outside India, especially since the services would not have any nexus with the territory of India. However, as per the Budget proposal, even the services provided completely offshore by a non-resident to a resident of India would be caught within the Indian tax net.

Under the existing law, a non-resident is taxable in India only on income that is sourced in India. In Ishikawajma-Harima Heavy Industries, a landmark case concerning the taxation of cross-border EPC contracts, the Supreme Court of India clarified that income from offshore services provided by a non-resident does not have an Indian source and hence would not be taxable in India. The absence of sufficient territorial nexus with India precludes the Government from taxing services that are rendered outside India. This principle was also recently applied by the Bombay High Court in Clifford Chance, where a UK-based law firm (then a general partnership) was not taxed on fees received by it from Indian clients for professional services rendered by its partners from outside India. The Court held that only those services that were rendered by the partners in India would have the required degree of territorial nexus to be subjected to tax in India.

The change proposed in the Budget has the effect of overriding the 'doctrine of territorial nexus' that was read into the 'law of the land' by the Supreme Court. The proposed alteration to India's source rules is likely to have adverse ramifications on most conventional cross-border service models. For example, now even the offshore service element in every EPC / turnkey contract would be taxable in India. This is also likely to influence the dynamics of international project financing. Likewise, income earned by foreign advisors and consultants would now be taxable even if no part of the service is performed in India, but simply because the same is utilized in India.

The proposed change may also give rise to double taxation issues especially in a situation where a foreign country refuses to grant its resident a credit for taxes paid in India under a conflicting or asymmetric source rule. Considering that the amendment is retroactive in nature, leading as far back to 1976, one can imagine the degree of controversy that this proposal can create. It may result in tax authorities re-opening all past cases within the limitation period of six years.

A similar proposal, sought to be introduced in the draft Direct Taxes Code, has been subjected to criticism from all quarters. The extra-territorial nature of the proposal and its retroactive application may face a number of constitutional challenges. The proposal also seems to conflict with various customary international law principles that restrict a State's right to tax income from offshore transactions. For these reasons, we believe that a departure from India's existing source rules should be avoided.

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