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Foreign firms in a royalty fix
- INTRICATE BALANCING ACT: Revenue sources increase manifold but demand needs to hold up

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BUDGET 2010 - AFTER EFFECT

Mumbai, March 1: For the second time in three years, the government has tried to fix a legal infirmity in income tax law with respect to royalty and licence fee payments made to overseas companies that have no permanent establishment in the country.

The rule change is likely to spark another bout of fierce litigation between tax authorities and foreign companies that provide a range of services to Indian entities that are not necessarily rendered within the country.

The battle stems from section 9 of the income tax act — a proviso that was introduced in the Finance Act of 1976 — and deals with payment of interest, royalty or fees for technical services to overseas entities with respect to the services they render.

The latest attempt to plug the legal lacuna seems quite brazen: the government says it will tax such payments whether or not “the non-resident has rendered services in India”.

This is a grab-all proviso that seeks to negate the effects and implications of a judgment handed down by the Karnataka high court in March 2009 in a case involving Jindal Thermal Power Company Ltd.

“The extra-territorial nature of the proposal and its retroactive application may face a number of constitutional challenges,” says Nishith Desai of the eponymous law firm. “It seems to conflict with various customary international law principles that restrict a state’s right to tax income from offshore transactions.”

Source rule

The government argues that the clause incorporated in 1976 introduced the concept of a source rule with respect to royalty and technical licence fee payments. The source rule is also recognised in the double taxation avoidance agreements that India has signed with many countries.

In the case of such payments, income would be deemed to have accrued or arisen in India to the non-resident. That was the legislative intent of the clause and, the government adds, it was the “settled position of law till 2007”. Two court rulings sent the government scrambling to fix the problem.

The first ruling was by the Supreme Court in 2007 in the case between Ishikawajima-Harima Heavy Industries Ltd and the department of income tax. The apex court ruled that for any income to be taxable in India there had to be sufficient territorial nexus between such income and the territory of India. It also ruled that while establishing territorial nexus, the service would have to be rendered and utilised in India.

Former finance minister P. Chidambaram first tried to blunt the implications of the ruling through a change in the Finance Act of 2007. The amendment meant that income would be included in the total income of the non-resident “regardless of whether the non-resident has a residence or a place of business or business connection in India”.

The government argued that the original legislative intent was that the *situs* of rendering service in India was not relevant as long as the services were utilised in India.

The Karnataka high court ruling in the Jindal case sent the government’s legal wordsmiths into a tizzy once again.

Jindal had signed up separate agreements with the US-based Raytheon-Ebasco Overseas Ltd and three other entities to commission a power plant in Bellary district. Two companies — Energy Overseas International Ltd and Badger Energy Inc — were subsidiaries of Raytheon. The third was state-owned Bhel.

Raytheon-Ebasco was to provide technical services entirely outside India. It would design the power plant, review quotations of suppliers, oversee start-up of the plant from its home office in the US, and have overall responsibility for the turnkey project.

Initially, Jindal deducted tax at source for payments to Raytheon for the 1996-97 assessment year but then stopped doing so.

Jindal challenged the tax authority’s ruling that it would have to shoulder the tax liability after failing to deduct tax prior to the payout to Raytheon. The company said Raytheon’s technical services were not rendered in India even though the services were utilised here and chose to rely on the Supreme Court verdict of 2007.

The Jindal counsel had argued that the apex court ruling had set twin requisites for the enforcement of the provisions of section 9: the service had to

be rendered in India *and* it had to be utilised in the country. The litmus test of tax liability required satisfaction of both conditions.

Citing the apex court ruling in the Ishikawajima-Harima Heavy Industries case, the high court ruled that the government's explanation of the 2007 amendment did not do away with the requirement of rendering of services in India for any income to be deemed to accrue or arise to a non-resident under section 9.

Can of worms

It is to negate the effects of this ruling that the government has now come up with a fresh amendment in the Finance Bill of 2010, which finance minister Pranab Mukherjee tabled in the Lok Sabha after presenting the budget last Friday.

Effectively now, income by way of interest, royalty or technical licence fees received by an overseas company shall become taxable whether or not it has a place of business in India and has rendered these services in India. The amendment takes effect from June 1, 1976.

"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 or turnkey contract would be taxable in India. This is also likely to influence the dynamics of international project financing," Desai said.