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Nexus Matters: India's Right to Tax

by Shreya Rao

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The existence of nexus between income and the taxing state is a prerequisite for the right to tax. However, the nature of income is often indeterminable, and there is little international consensus on the most suitable criteria to establish nexus.

In 1923 the Financial Committee set up by the League of Nations examined the issue and concluded that economic allegiance[1] between income and the taxing state is the basis of tax jurisdiction. Criteria as varied as residence, nationality, domicile, and source were discussed as being indicative of economic allegiance.

Of those, residence — known as the subjective criterion[2] — creates unlimited tax liability on the subject of tax. It is linked to physical factors such as period of stay and place of incorporation. Source, known as an objective criterion,[3] creates limited tax liability to the extent of source. Source depends on the characterization of the income and is established by placing reliance on legal fictions linked to physical factors such as the existence of a permanent establishment.

Theoretically, there should be no double taxation if uniform jurisdiction criteria are applied internationally. However, although the theory and practice of international taxation have evolved significantly since 1923, there is still little consensus on the most appropriate jurisdiction criteria. While residence is favored by the capital-exporting countries and source is favored by capital-importing countries, many countries, including India, adopt residence-based taxation for residents and source-based taxation for nonresidents,[4] a practice that could result in double taxation.[5]

Recognizing the problems arising from incompatible jurisdiction criteria, states have developed a network of double taxation avoidance agreements and treaties to internally divide fiscal jurisdiction. Some also offer unilateral credit to residents regarding taxes paid in the foreign-source country.

However, treaties continue to rely on traditional source criteria to determine the right to tax, source criteria that, as mentioned above, rely on physical factors[6]

[1]Report on Double Taxation Submitted to the Financial Committee by Profs. Bivens, Einavai, and Seligman, and Josiah Stamp, at 18, League of Nations Doc. E.F.S.73 F.19 (1923).

[2]*Source and Residence: New Configuration of Their Principles*, IFA: Cahiers de Droit Fiscal International, Vol. 90a, Buenos Aires (2005), p. 30.

[3]*Id.*, p. 29.

[4]*Id.*, p. 40.

[5]*Id.*, p. 50.

[6]*See* Barry Spitz, *International Tax Planning* (2nd ed.), Butterworths, London (1983), p. 20: ''The principal connecting factor with regard to a taxable event is the real or deemed source. For example, in the case of profits deriving from the sale of goods,

(Footnote continued on next page.)

such as fixed place location of assets, or presence of relevant persons in a jurisdiction to establish source. Those criteria relate to an economy that required physical presence of capital or labor for the carrying on of any economically significant activity.

Globalization has rendered the traditional source criteria inadequate by:

- Increasing the contribution of knowledge-based and other services to global revenue. Services are fluid and unascertainable in nature and can transcend international borders with minimal transaction costs. ''Today, permanence and physical location at a specific geographical spot are not a prerequisite for the performance of an economically significant business activity.''[7]
- Significantly increasing the number of cross-border transactions. Plummeting transaction costs have increased intercountry interdependence among businesses.

Traditional source criteria are failing to outline the limits of tax jurisdiction,[8] especially in cross-border industries such as e-commerce, project management, and financial services. Consequently, most states are uncertain about what they may tax.

This article proceeds on the hypothesis that we must revisit the concept of nexus for effective international taxation of cross-border services. It does not explore issues of characterization but restricts its scope to an analysis of nexus and the right to tax.

Overview of Indian Tax Regime

The Income Tax Act, 1961 (ITA) governs taxation of income in India. According to section 5 of the ITA, Indian residents[9] are taxable on their worldwide income, and nonresidents are taxed only on income that has its source in India.[10] Section 6 of the ITA defines who may be a tax resident and contains different residency criteria for companies, firms, and individuals. The scope of section 5 is expanded by the ''legal fiction contained in section 9,''[11] which deems certain kinds of income to be of Indian source.

The ITA favors source-based taxation as compared to the OECD model conventions or treaties entered into by many developed countries that favor residence-based taxation.[12] Indian courts have supported source-based taxation in several cases in the past.[13]

Business Income

The business income of a nonresident is taxable in India under section 9(1)(i) of the ITA only if it accrues or arises, directly or indirectly, through or from any business connection in India, property in India, asset or source of income in India, or through the transfer of an Indian capital asset. Explanation 2 of section 9(1)(i) contains an inclusive definition of business connection; as per which a business connection is said to exist if any person carrying on a business activity acts on behalf of a nonresident and:

- has and habitually exercises an authority to conclude contracts on behalf of the nonresident, unless the activities are limited to the purchase of goods or merchandise for the nonresident;
- has no such authority, but habitually maintains in India a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the nonresident; or
- habitually secures orders in India, mainly or wholly for the nonresident or its affiliates.

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the source might be the place of the execution of contract, the place where a trader or manufacturer employs his capital or where he exercises his activities, while in the case of a real property tax or a capital gains tax on the sale of real property, geographic source or situs would normally constitute the connecting factor.'' *Supra* note 2, p. 14.

[7]Arvid A. Skaar, *Permanent Establishment: Erosion of a Tax Treaty Principle* (1st ed.), Kluwer Law and Taxation Publishers, Deventer, Netherlands (1991), p. 14; *see also* Skaar, pp. 14-15, for a discussion on the difficulty of applying the PE concept in the new economy and resulting issues regarding the extent of fiscal jurisdiction.

[8]''The connection between a business activity and a specific geographic jurisdiction is gradually weakening, as a result of technological development. Therefore applying the classical concepts of source and residence becomes increasingly difficult.'' *Supra* note 2, p. 50.

[9]Defined in section 6 of the ITA.

[10]Income is said to have its source in India if it accrues or arises in India, is deemed to accrue or arise in India, or is received in India. *See* sections 4 and 5 of the ITA.

[11]Sampath Iyengar, *The Law and Practice of Income Tax,* Vol. 1 (10th ed.), Bharat House, New Delhi (2005), p. 1180.

[12]''India primarily follows the UN model convention and one therefore finds the tax-sparing and credit methods for elimination of double taxation in most Indian treaties as well as more source-based taxation in respect of the articles on 'royalties' and 'other income' than in the OECD model convention. Indian treaties include a separate article on FTS leading to taxation on a gross basis if the fees are paid for the types of service covered thereunder. This would result in more source-based taxation than under the UN/OECD model conventions as, ordinarily, remuneration for managerial, technical or consultancy services would not be taxed in the state of source unless it was attributed to a PE or a fixed base situated therein. Thus, India levies more source based taxation than the UN/OECD model conventions.'' *Supra* note 2, p. 340.

[13]*See CIT v. PVAL Kulandagam Chettiar* ((2004) 267 ITR 654) and *CIT v. RM Muthaiah* ((1993) 202 ITR 508).

The traditional meaning of business connection was given in *CIT v. RD Aggarwal,*[14] in which the Supreme Court of India held that:

> Business connection means something more than business. It presupposes an element of continuity between the business of the nonresident and his activity in the taxable territory, rather than a stray or isolated transaction.

If the benefits of a treaty are available, as per article 7 of many Indian treaties, the business income of the nonresident taxpayer is taxable in India only if it is attributable to a PE of the taxpayer in India.[15] PE is defined in article 5 of most Indian treaties, and the definition is narrower than that of business connection.

The business income of nonresident entities is taxed at the rate of 40 percent.[16]

Fees for Technical Services

Explanation 2 to section 9(1)(vii)[17] of the ITA defines fees for technical services (FTS) as payments for managerial, technical, or consulting services.[18] Under section 9(1)(vii), FTS payments are taxed in India (at the rate of 10 percent[19] on a gross basis) if they are:

- payments by a resident of India (unless they are made for business outside India);[20] or
- payments by a nonresident if the services are used in India or for the earning of income from a source in India.[21]

The FTS provision is expansively worded and could subject to Indian tax certain payments that have no nexus with India. Therefore, Indian jurists have opined that the provision should be interpreted narrowly.[22]

Article 12 of many Indian treaties contains a narrower definition of FTS/fees for included services; FTS means consideration for:

- services that are ancillary or subsidiary to the application or enjoyment of any right, property, or information toward which royalties have been paid; or
- services that offer technical knowledge or experience for the benefit of the customer.[23]

Under the ITA and most Indian treaties, FTS are taxable in India at the rate of 10 percent on a gross basis.[24] Income not falling within the definition of FTS is considered business income.[25]

Applicability of Treaty Benefits

In section 90(2) of the ITA, if the taxpayer is the resident of a country with which India has a treaty, the provisions of the ITA apply only to the extent they are more beneficial to the taxpayer.

Industry-Specific Analysis

Does the PE Fiction Continue to Be Functional?

E-Commerce

Physical presence of an enterprise in a country is no longer required for the carrying on of any economically significant activity.

Suppose ABC is a database service provider incorporated outside India, with a consumer base exclusively comprising Indian residents (subscribers), who enter into an online end-user license agreement and

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[14](1965) 56 ITR 20.

[15]Under *CIT v. Vishakhapatnam Port Trust* ((1983) 144 ITR 146 (AP)), a PE connotes a projection of the foreign enterprise itself into the territory of the taxing state in a substantial and enduring form.

[16]All rates mentioned are as introduced by the Finance Act, 2007 and are exclusive of surcharge at the rate of 10 percent (for residents) and 2.5 percent (for nonresidents), plus education cess at the rate of 2 percent and secondary and higher education cess at the rate of 1 percent on tax plus surcharge.

[17]Explanation 2 to section 9(1)(vii)(c) defines FTS to mean:

> any consideration (including lump sum consideration) for the rendering of any managerial, technical or consultancy services (including the provision of services of technical or other personnel) but . . . not . . . consideration for any construction, assembly, mining or like project undertaken by the recipient or consideration which would be income of the recipient chargeable under the head ''salaries.''

This is an exhaustive definition.

[18]Managerial, technical, and consulting services have not been defined and therefore are understood in accordance with commercial parlance.

[19]Assuming the agreement has been entered into after June 1, 2005.

[20]Section 9(1)(vii)(b).

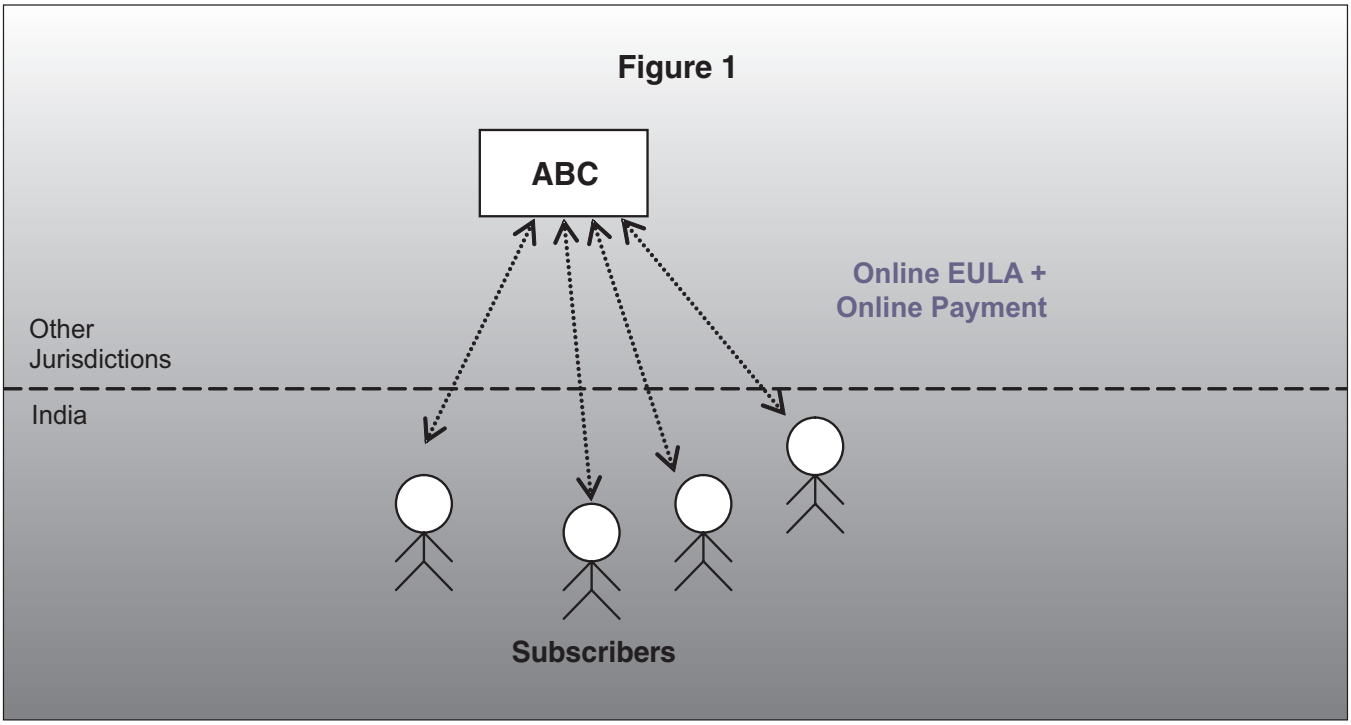
[21]Section 9(1)(vii)(c).

[22]''If the Indian Parliament can cast the net wide enough to collect taxes in such cases where the foreigner's income has no nexus with India, only because the income is derived from a transaction with an Indian, it can equally levy a tax on a hotel in a foreign country where an Indian goes to stay or dine, or on a foreign store where an Indian buys shirts or grocery, or on a foreign physician whose services are sought by an Indian while abroad. Not only are these clauses contrary to the well settled international norms of taxation on a foreigner in respect of his income accruing, arising and received outside the taxing state, but they are against the letter and the spirit of the various tax treaties entered into by India with foreign countries, though they do not and cannot supersede those treaties.'' Kanga, Palkhivala, and Vyas, *The Law and Practice of Income Tax* (9th ed.), Butterworths, London (2004), p. 270.

[23]While the term ''make available'' has not been defined, in *Raymond Limited v. DCIT* (86 ITD 791) it was held that services could be considered to make available technical knowledge and experience when the recipient can make use of technical knowledge by himself in his own business or for his own benefit and without recourse to the service provider in the future.

[24]Surcharge, education cess, and secondary and higher education cess are not applicable to treaty rates.

[25]*Commissioner of Income Tax v. Copes Vulcan Inc.* (167 ITR 884).



make online payments to ABC via credit card. ABC has no physical presence or PE in India. (See Figure 1.)

If ABC's income from the sale of subscriptions is considered business income[26] in accordance with article 7 of many Indian treaties, it would not be taxable in India unless attributable to a PE of ABC in India. Since ABC can carry on its entire business in India without having a PE in India, the PE fiction would fail to indicate the connection between the business profits of ABC and the consumer base located in India.[27] Alternative PE models, which are specific to e-commerce, have been endlessly debated.[28] However, the PE concept is essentially based on the supposition that physical presence is a precondition for the indication of source; it cannot be adapted well to e-commerce.

Therefore, it has been suggested that the way in which source is defined for electronic transactions should be changed.[29] In these circumstances, the business connection concept contained under Indian domestic law and described in *RD Aggarwal* may prove to be a more suitable indicator of nexus because it would bring the business income of ABC to tax in India if it is attributable to any continuous, real, and close connection of ABC in India.

Engineering, Procurement, and Construction Agreements

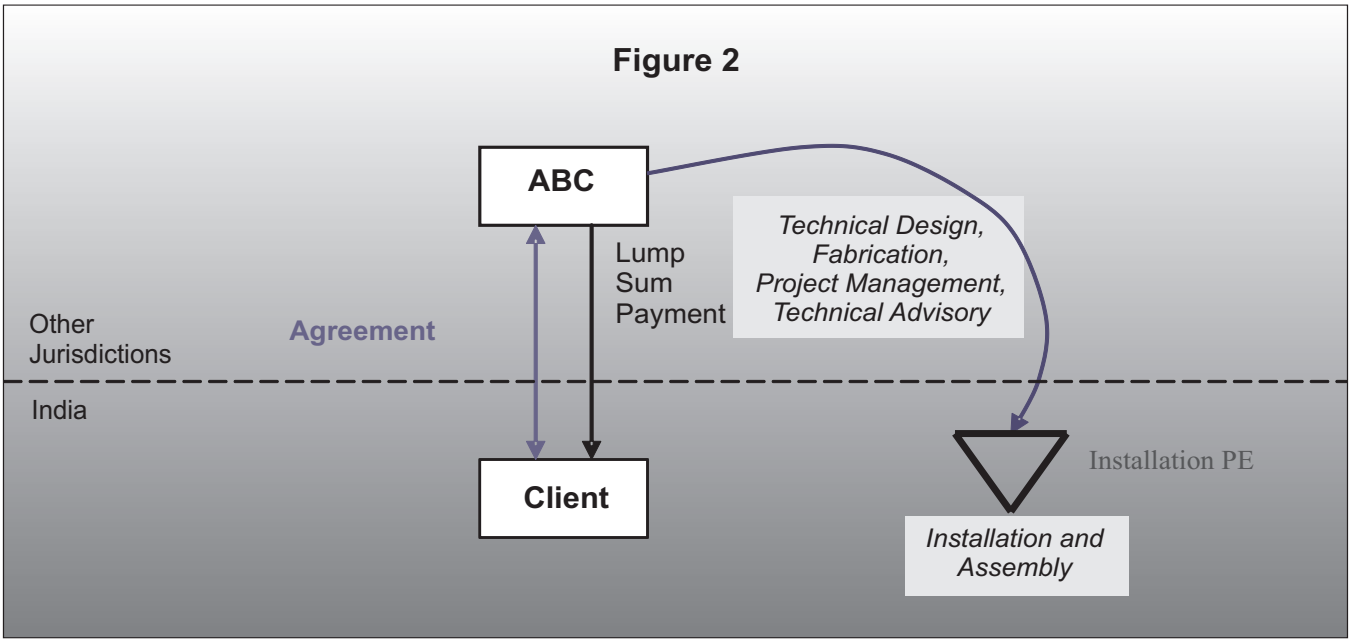
Plummeting transaction costs have led to the growth of multijurisdiction engineering, procurement, and construction agreements (EPC contracts) for large-scale infrastructure projects (EPC projects). Those arrangements are a nightmare for taxpayers and administrators alike.

[26]In *Dun & Bradstreet Espana SA* ((2005) 272 ITR 99 (AAR)), the Authority for Advance Rulings (AAR) held that income from the online sale of business information reports would be considered business income. Similarly, in *Wipro Ltd. v. Income Tax Officer* (278 ITR 57), the Bangalore ITAT held that access to a database containing copyrighted information is not equivalent to a right in a copyright. On that basis, it characterized the payments as the business income of the taxpayer. However, in *Cargo Community Network (P.) Ltd.* ((2007) 158 Taxman 243), the AAR held that when a foreign company provides access to an online database containing an elaborate mechanism for cargo booking, the subscription amounts received by the foreign company would be in the nature of a royalty. Although AAR rulings are binding only on the parties involved, they do have persuasive value.

[27]''One factor that has challenged traditional criteria is e-commerce, since the attribution of income to each participant and its connection to the taxing powers of a specific country pose complex challenges which have still not found a fair solution in international legislation.'' *Supra* note 2, p. 27.

[28]*See supra* note 2, p. 51.

[29]In his doctoral thesis on e-commerce and source-based income taxation, Dale Pinto argues: ''Source based taxation is theoretically justifiable for income that arises from international transactions that are conducted in an electronic commerce environment. The way in which source is currently defined for electronic transactions needs to be reconfigured.'' Pinto proposes that the concept of PE may be maintained, but must be supplemented with a new test for tax nexus in source countries. *C.f. supra* note 2, p. 87.



Suppose, for example, that a foreign entity, ABC, contracts with an Indian client to install machinery in India. During the EPC project, ABC conducts technical design, fabrication of parts, and project management activities outside India, and installation activities (consisting of about 20 percent of the project) in India. ABC has an installation PE in India. ABC receives a lump sum payment for the EPC project, which is characterized as its business income under the applicable treaty. (See Figure 2.)

ABC has a PE in India, and under article 7 of many Indian treaties, its business profits would be taxable to the extent they are attributable to the PE in India. Considering that the offshore activities constitute a major part of the project, what portion of the lump sum payment could be taxable in India?

There is little international consensus on the principles of PE attribution. The OECD[30] and the International Fiscal Association[31] have discussed various models and theories, inconclusively.

In India, based on the *Roxon OY*[32] and *Morgan Stanley and Co.*[33] rulings, and Circular 5 of 2004 issued by the Central Board of Direct Taxes, the position was that if payment had been made on an arm's-length basis, no further income could be attributed to the PE. However, the Mumbai Income Tax Appellate Tribunal (ITAT) recently applied the theory of dual attribution in *SET Satellite (Singapore) Pte Ltd. v. DIT,*[34] holding that mere payment of an arm's-length price to a dependent agent cannot eliminate the tax liability of the foreign company in India. Some treaties also contain a force of attraction clause in which income could be attributed to a PE if it is regarding similar activities carried on by a dependent agent in the same country.

Under rule 10 of the Income Tax Rules, if there is uncertainty about income attributable to activities carried on in India, the revenue officer may decide.

Because of the lack of clarity about the theories of attribution, the Indian revenue authorities at the lower levels in our example may tax the entire lump sum payment.

However, the Supreme Court examined the issue of attribution in *Hyundai Heavy Industries Co Ltd*[35] and held that payments toward offshore activities would not be taxable in India in the absence of an economic nexus of such payments with India.[36] The court held that an

[30] *See* the OECD's discussion draft on the attribution of profits to permanent establishments (2004).

[31] *See The Attribution of Profits to Permanent Establishments*, IFA: Cahiers de Droit Fiscal International, Vol. 91b, Amsterdam (2006).

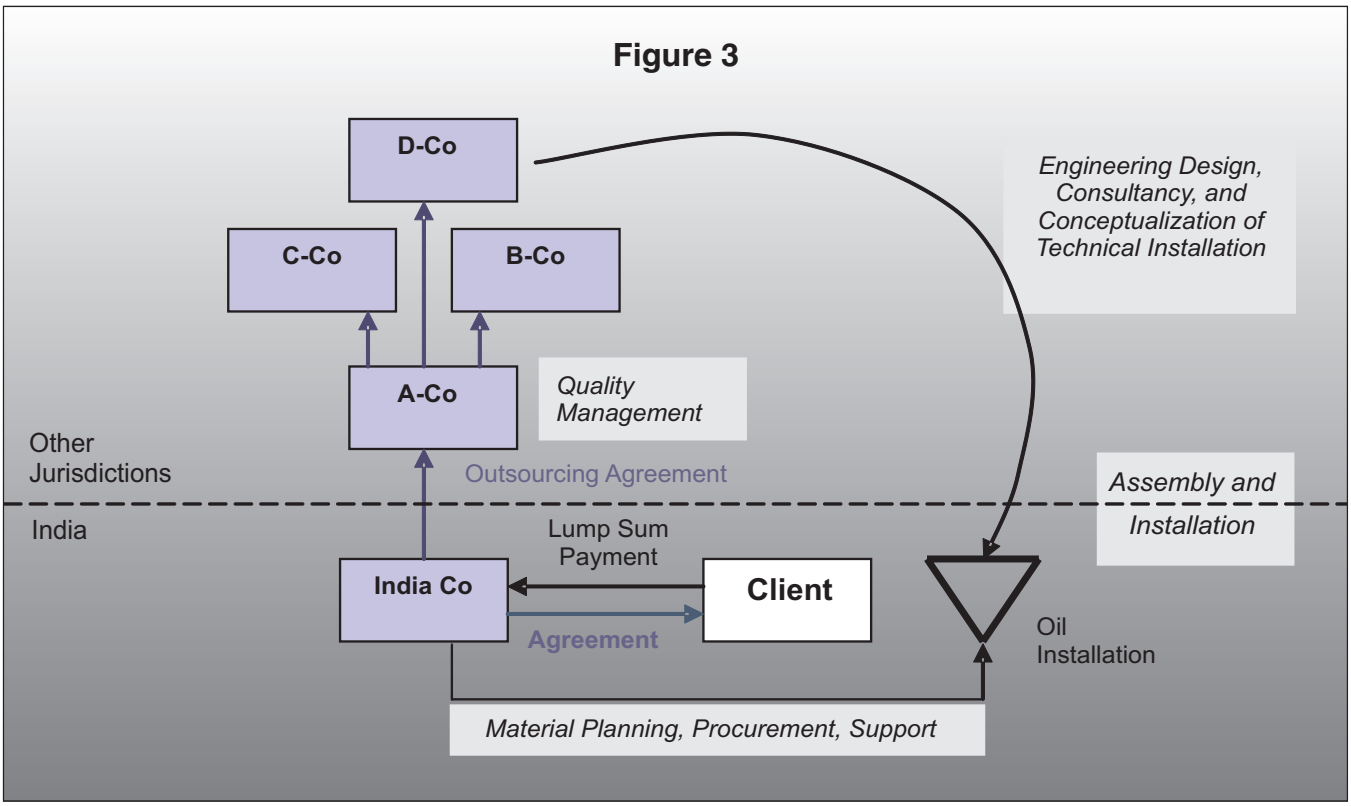
[32] 103 TTJ 891 (Mum ITAT).

[33] 284 ITR 260 (AAR).

[34] 108 TTJ 445 (Mum ITAT).

[35] *CIT and Another v. M/s. Hyundai Heavy Industries Co Ltd.* ((unreported) Civil Appeal No. 2735 of 2007 (arising out of SLP (C) No. 4839 of 2007)).

[36] Applying these principles, it was held against the facts of the case that as the installation activities took place after the delivery of fabricated platforms to agents of ONGC outside India, the PE came into existence only after the first leg of the transaction was complete. Therefore, it was held that payments made toward fabricated platforms could not be attributable to the PE.



artificial division between Indian profits and foreign profits is necessary for the demarcation of tax jurisdiction over the operations of a company and that the PE would be taxable in India only regarding its real profits that it would have earned if it were wholly independent of the foreign enterprise.

Similarly, in *Ishikawajima Harima Heavy Industries Ltd. v. DIT,*[37] the Supreme Court held that the concept of territorial nexus is fundamental in determining taxability of any income in India and that income from offshore services would not be taxable in India merely because the activities are rendered in relation to an Indian turnkey project.[38]

Those rulings are responses to the ambiguities in law regarding the extent of source. They reiterate that the mere existence of a PE should not give India the right to tax the entire payment for onshore and offshore services because the payments received for offshore services would have no nexus with India. The principle of nexus has thus been used to undo the damage caused by the failure of the PE fiction.

Therefore, in our example, ABC's income from offshore activities should not be taxable in India.

Does the FTS Fiction Continue to Be Functional?

Outsourcing Technical Services in EPC Contract

Suppose, for example, that an Indian entity, India Co., is part of a multinational project management group. India Co. procures a contract from an Indian client and outsources the technical aspects of the contract to A-Co., located outside India. A-Co. in turn

[37]288 ITR 408 (SC).

[38]A similar view has also been taken by the AAR regarding Bechtel [*In Re: Advance Ruling P. No. 13 of 1995* (228 ITR 487 (AAR))], when a French company entered into a single indivisible EPC contract with an Indian entity. Most of the design and manufacturing work was carried on outside India, and only the installation activity was carried on in India. The AAR held that:

> With modern advances in scientific technologies, a single point accrual to the execution of such projects cannot be attributed. . . . The setting up of such a plant is a formidable and complicated task requiring the coordinated effort of specialists in varied fields of knowledge, information, experience and expertise. . . . These services, expertise and knowledge may be available with one person or may

(Footnote continued in next column.)

> be acquired from different persons. . . . Even viewed as a business contract for the putting up of a plant in India, its execution involves operations involving rendering of services at various places in different areas of specialization and, on a proper understanding of the provisions of the Act and the DTAA, only that part of the profits referable to the operations carried out in India can be brought to tax in India.

outsources various parts of the contract to other group companies such as B-Co., C-Co., and D-Co. (each a Group Co.). (See Figure 3.)

Under section 9(1)(vii)(b) of the ITA, FTS payments made by an Indian resident are taxable in India unless they relate to a business carried on by the resident outside India. Therefore, in our example, payments received by A-Co. would be taxable at the rate of 10 percent on a gross basis.

Further, under section 9(1)(vii)(c), FTS payments made by a nonresident are taxable if they are payable regarding services used in a business or profession carried on by that person in India or for acquiring or earning any income from any source in India. A-Co. carries on its business outside India and has no business in India. However, could it be said that A-Co. makes the payments to the Group Cos. to acquire income from a ''source'' in India?

Although source is not defined in the ITA, it is accepted that the source of income is where the income-yielding activity takes place.[39] The ruling in *Lufthansa Cargo India Private Ltd v. DCIT* [40] held that in the context of an international transaction, source can be said to be outside India if:

- the payer is a nonresident;
- the contract with the nonresident is made outside India; or
- the activity that yields income takes place outside India.

Since the income-yielding activity is the installation activity in India, and since A-Co. makes payments to the Group Cos. for the installation activity, the FTS income of the Group Cos. may be taxable in India on a strict reading of section 9(1)(vii)(c). That would result in a double taxation of income from the same activity (on payments from India Co. to A-Co., and A-Co. to Group Cos).[41]

Such double taxation of income from intangibles is not unique to India. For example, in the context of taxation of second-tier royalty payments in the United States, it has been held that that such taxation ''could cause a cascading royalty problem, whereby multiple withholding taxes could be levied on the same royalty payment as it is transferred up a chain of licensors.''[42]

In that situation, the FTS provision should be interpreted in light of the nexus rule, in line with the provisions of the ITA,[43] the Indian Constitution,[44] general principles of international law,[45] and the Supreme Court's decisions in *Hyundai Heavy Industries*[46] and *Ishikawajima Harima.*[47] Although a strict interpretation of domestic law may render the secondary FTS income of the Group Cos. taxable in India, that income would have no nexus with India and cannot be taxed in India merely because the Group Cos. render services in relation to an Indian installation.

Financial Consultancy Services

Suppose foreign funds (fund) are set up to invest into Indian securities. The fund sets up an investment manager (IM) outside India, which receives management fees and a share in the profits of the fund as consideration for its services. (See Figure 4.)

Since the fund's source of income is the investment activity in India[48] and the services of the IM are obtained for the purpose of that investment activity, payments made by the fund to the IM could be subject to tax in India. As in Figure 3, this is an absurd extension of fiscal jurisdiction; the services rendered by the IM are in the course of its business outside India, to the fund located outside India, and the fees received by the IM are independent of the performance of the fund in India. Therefore, section 9(1)(vii)(c) would have to be narrowly interpreted, keeping nexus in mind.

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[39]In *Asia Satellite Telecommunications Ltd. v. DCIT* (85 ITD 478), it was held that source refers to the activity resulting in the income. In this case, the income of the nonresident entity, paid by another nonresident entity, was considered taxable in India because the income-generating activity was in India.

[40]274 ITR 20 (AT).

[41]Such double taxation has also been observed in treaty situations. In *White Consolidated Industries* (AAR No 250 of 1995), it was held that the royalty paid by one U.S. company to another U.S. company for the use of a trademark, which was, in turn, also used by its Indian subsidiary, was held to be taxable in India and was subject to a withholding tax on a gross basis.

[42]*SDI Netherlands B.V. v. Commissioner* (Docket No. 23747-94, 107 TC—, No. 10, 107 TC 161, filed October 2, 1996).

[43]The ITA does not have extraterritorial jurisdiction because it ''restricts itself to persons or incomes that have a real and substantial nexus with the territory of India.'' *Wallace Brothers & Company, Limited v. CIT Bombay City* (50 Bom. L.R. 482). For income to be considered taxable in India, some sort of territorial connection must exist between the taxing state and the person whose income is to be taxed. *AH Wadia v. CIT* (51 Bom. L.R. 287).

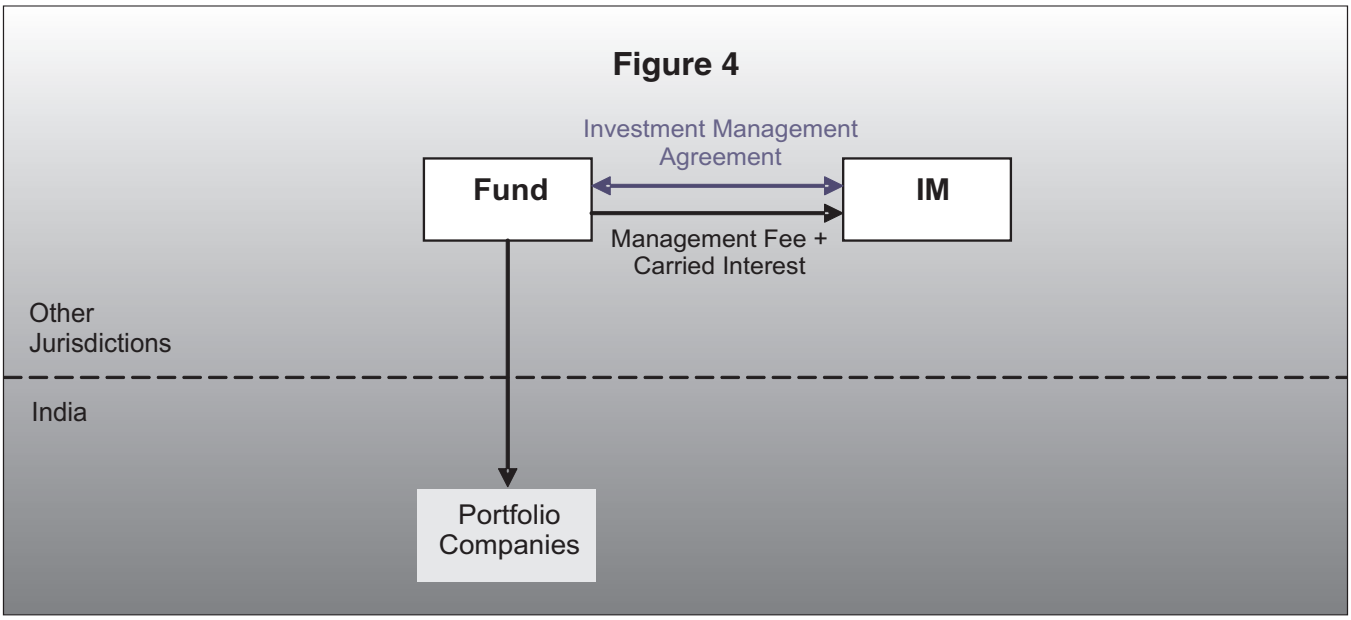
[44]The Indian Constitution does not bar the enactment of legislation with extraterritorial applicability. However, in *Bombay v. RMD Chamarbaugwalla* (AIR (1957) SC 874) and *Electronics Corp. of India Limited v. Commissioner of Income Tax* (AIR (1989) SC 1707), it was held that the provocation for the extraterritorial law must be found within India itself.

[45]The principle of comity of nations demands respect for jurisdiction, including the fiscal jurisdiction of states.

[46](Unreported) Civil Appeal No. 2735 of 2007 (arising out of SLP (C) No. 4839 of 2007).

[47]288 ITR 408 (SC).

[48]In *Joint CIT v. Montgomery Emerging Markets Fund* (100 ITD 217), it was held that a foreign institutional investor had a source of income in India and that that ''source of income is the stream or fountain out of which the income springs to the assessee.''



Conclusion

The case studies demonstrate the uncertainty resulting from inadequate source rules. A country's source jurisdiction is limited by deeming source fictions[49] — fictions that must be read in context, keeping in mind the purpose for which they were created.[50] However, the context in which the fictions were created no longer exists today; the economy has completely changed.

When traditional fictions and source rules fail to perform, resulting in an absurd extension of the state's fiscal jurisdiction, it is useful to revisit the theory of nexus, like the Supreme Court of India has done, to understand the limits of the state's right to tax. The fictitious criteria must not be seen as an end in themselves, but as merely indicative of the economic allegiance of the income with the state. ◆

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[49] *E.g.*, the deeming provisions in section 9 of the ITA, or those enshrined in the PE concept.

[50] *State of Bombay v. Pandurang Vinayak* (AIR 1953 SC 244); *see also* Justice GP Singh, *Principles of Statutory Interpretation* (10th ed.), Wadhwa & Co., Nagpur (2006), p. 350.