Justice Jennifer Davies

IATJ 7th Assembly

September 30th

October 1st, 2016

Madrid, Spain

Tech Mahindra Limited v Commissioner of Taxation

International Association of Tax Judges

Issues:

Whether Australia has the right to tax a resident of India conducting business through a permanent establishment in Australia on income derived from services performed in India for customers located in Australia?

The determination of the issue depends on the interaction of Article 7 (the business profits rule) and Article 12 (royalties) of the Double Tax Agreement between India and Australia.

Article 7:

Business Profits

(1) The profits of an enterprise of one of the Contracting States shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to:

(a) that permanent establishment; or

…

(3) In the determination of the profits of a permanent establishment, there shall be allowed as deductions…expenses of the enterprise…

…

Article 7 (continued):

(7) Where profits include items of income which are dealt with separately in other Articles of this Agreement, then the provisions of those Articles shall not be affected by the provisions of this Article.

Article 12:

Royalties

(1) Royalties arising in one of the Contracting States, being royalties to which a resident of the other Contracting State is beneficially entitled, may be taxed in that other State.

(2) Such royalties may also be taxed in the Contracting State in which they arise, and according to the law of that State, but the tax so charged shall not exceed:

(b) in the case of other royalties:

(i) during the first five years of income for which this agreement has effect:

A. …

Article 12 (continued):

B. in all other cases: 20% of the gross amount of the royalties; and

(ii) during all subsequent years of income: 15% of the gross amount of royalties

(3) (g) The term “royalties” in this Article means payments or credits, whether periodical or not, and however described or computed, to the extent to which they are made as consideration for:

the rendering of any services (including those of technical or other personnel) which make available technical knowledge, experience, skill, no-how or process or consist of the development and transfer of a technical plan or design…

Article 12 (continued):

(4) The provisions of paragraphs (1) and (2) shall not apply if the person beneficially entitled to the royalties, being a resident of one of the Contracting States, carries on business in the other Contracting State, in which the royalties arise, through a permanent establishment situated therein, or performs in that other State independent of personal services from a fixed base situated therein, and the property, right or services in respect of which the royalties are paid or credited are ***effectively connected with*** such permanent establishment or fixed base. In such a case, the provisions of Article 7 … shall apply.

(emphasis added)

Facts:

- Taxpayer is a resident of India and carries on business through a permanent establishment in Australia.
- Taxpayer provides information technology to entities resident in Australia (the Australian customers).
- The services which the taxpayer provided to the Australian customers were performed partly by employees located in Australia (the Australian services) and party by employees located in India (the Indian services).
- It was common ground that the income derived from the performance of the Australian services was income attributable to the permanent establishment in Australia and the taxpayer was liable to tax in Australia on that income pursuant to Article 7(1)(a) of the DTA.
- It was common ground that payments made by the Australian customers in respect of the Indian services are royalties within the meaning of Article 12(3)(g) of the DTA.

Taxpayer's Arguments:

Taxpayer argued that the payments for the Indian services were not taxable by Australia either pursuant to Article 12(2) or Article 7(1)(a).

This argument turned on the meaning of the expression "effectively connected" in Article 12(4).

It was argued that:

- The Indian services were "effectively connected" with the taxpayer's permanent establishment based on the fact that the "contractual rights" that gave rise to the payments were "carried on through the permanent establishment".

Taxpayer's Arguments (continued):

> "…the Indian Services were performed in concert with the services performed through the permanent establishment. It was only the Indian Services in combination with the Australian Services that together satisfied the contractual obligations to the Australian Customers. The close relationship had the consequence that the Indian Services were effectively connected with the permanent establishment."

- Therefore by Article 12(4), Australia did not have taxing rights under Article 12(2) but only taxing rights under Article 7(1)(a).
- Article 7(1)(a) did not apply because the payments were not "attributable to" the permanent establishment.

Taxpayer's Arguments (continued):

- Australia loses the right to tax the income where there is an effective connection between the payments and the permanent establishment which does not satisfy Article 7(1).

It was common ground that the payments in respect of the Indian services were NOT "attributable to" the permanent establishment within the meaning of Article 7(1)(a).

Commissioner's Argument:

- The exclusion for which Article 12(4) provides did not apply because the Indian services were not "effectively connected" to the permanent establishment.
- The words "effectively connected" with a permanent establishment in Art 12(4) are coextensive with the words "attributable to" a permanent establishment in Art 7(1).
- Art 12(4) gives priority to Art 7 where the criteria in Art 7(1)(a) are met so as to permit Australia to tax the royalties paid in respect of the Indian services as part of the profits of the permanent establishment, instead of the capped rate under Art 12.

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- Taxpayer's construction was not accepted.
- The exclusion in Article 12(4) did not apply.
- The Taxpayer was liable to Australian tax at a capped rate on the payments for the Indian services pursuant to Article 12(2).

Reasoning:

The primary Judge gave four reasons for preferring the Commissioner's construction:

- The purpose of Article 12(4) is to entitle the source state where the royalties arise to impose tax on the net profit under Article 7(1), rather than the capped rate under Article 12(2) where there is an effective connection between the payments and the permanent establishment.
- The words "effectively connected" with the permanent establishment are intended to encapsulate in a shorthand way the different tests of connection under Article 7(1)(a) which is regarded as sufficient justification for permitting a contracting state to tax profits of an entity notwithstanding that it is not a resident of that state.
- The taxpayer's construction leaves the concept of "effectively connected" undefined.

Reasoning (continued):

- The Commissioner’s construction is consistent with other case law on Article 10 of the DTA between Australia and Singapore (the equivalent to Article 12 of the Indian DTA) that Article 10(4) makes clear that the royalty Article is not to apply to a case falling within the business profits Article: in other words, the business profit Article takes priority over the royalty Article.

Appeal:

The taxpayer appealed to the Full Federal Court. The appeal has been heard and the decision reserved.

On appeal, the taxpayer argued that if Article 12(4) applies, Australia was never allocated a right to tax the payments as royalties under Article 12(2) as the allocation is governed by Article 7.

- The expressions “effectively connected” in Article 12(4) and “attributable to” in Article 7 are not coextensive.
- Critically, Article 12(4) is engaged if the services are “effectively connected with” the permanent establishment whereas under Article 7 the “profits” must be “attributable to” the permanent establishment to give Australia taxing rights.

Appeal (continued) :

- The language requires identification of the nature of the connection between the various identified matters and the permanent establishment for the purpose of determining whether the various payments should be “assimilated” into business profits so that the allocation of taxing rights might be dealt with Article 7.
- The result of the effective connection between the services and the permanent establishment is that the taxing rights are not to be allocated by the royalty Article but by the business profits Article.
- Whether Australia has taxing rights will depend upon whether the amounts “assimilated to business profits” are attributable to the permanent establishment.

Commissioner's Arguments:

The Commissioner argued that:

- If the payments are royalties for the purposes of Article 12, Australia has taxing rights under Article 12(2) subject to the exclusion in Article 12(4).
- If Article 12(4) does not apply, Australia has the right to tax the payments subject to the cap in Article 12(2).
- If Article 12(4) applies, Australia has the right to tax the net profits under Article 7.
- Article 12(4) does not disentitle Australia from taxing the fees as royalties.
- The meaning of "effectively connected with" should be understood as "in effect connected with" or "actually connected with".
- The phrase, so understood, imports an element of causality between the services and the permanent establishment.

Competing constructions:

The competing constructions are:

- On the Commissioner’s construction: “royalties” that are paid for “property right or services” that are “effectively connected” with a permanent establishment are governed by Article 7 which allocates to Australia the right to tax the royalties at more generous rates, otherwise the royalties are taxable by Australia at the capped rates in Article 12(2).
- On the taxpayer’s construction, where Article 12(4) applies, Australia does not have taxing rights in respect of the “royalties” unless Article 7 applies to the payments in question. In this case, Australia has no taxing rights because the royalties are not attributable to the permanent establishment.

Answer:

Addendum:

- *Tech Mahindra Limited v Commissioner of Taxation* [2016] FCAFC 130: Appeal dismissed.
- "Royalties" taxed by state of source either as part of business profits under Article 7 where such royalties are attributable to a permanent establishment in that state, or separately under Article 12.
- Article 12(4) and Article 7 have a co-extensive operation.
- "Effectively connected with" in Article 12(4) encapsulates the test of connection under Article 7(1)(a) – as part of business profits attributable to the permanent establishment in the source state.
- "Effectively connected with" means having a real or actual connection with the activities carried on through the permanent establishment.