Apex Court Holds Success Fees Taxable as FTS

This article explains and summarises a recent ruling of the Supreme Court in the case of GVK Industries Limited, where the Supreme Court held on 18th February 2015 that success fees charged by a non-resident entity for fund raising activities of Indian company is taxable as fees for technical services (FTS) under clause (b) of Section 9(1)(vii) of the Income-tax Act, 1961. The Supreme Court, while determining the taxability of services has clarified the meaning of 'consultancy' to mean an advice/opinion and deliberated on the concept of the source rule as well. The article provides a clear analysis of the ruling along with the legislative background on the taxability of services in the nature of FTS. Please read on...

I. Setting the Context...

The deeming provision of Section 9(1)(vii) of Income-tax Act, 1961 (hereafter referred to as the Act) states that income, which meets the definition of 'fees for technical services' specified in the sub Section will be deemed to accrue or arise in India and hence, become taxable in India. Fees for Technical Services (hereafter referred to as 'FTS') have been defined in *Explanation 2 to Section 9(1)(vii)* to include consideration for rendering managerial, technical or consultancy services. The terms 'managerial', 'technical' and 'consultancy' have not been defined in the Act and it has been held on various occasions that the meaning shall have to be imported based on their understanding in common parlance.

(Contributed by Committee on International Taxation. Comments can be sent to citax@icai.in)

The expression 'management' should be interpreted as per its normal business meaning or ordinary meaning. Mumbai Income Tax Appellate Tribunal (ITAT) in the case of *Linde AG*[1] observed that a managerial service is towards the adoption and carrying out the policies of an organisation. It is of a permanent nature for the organisation as a whole. Similarly, the Bombay High Court in the case of *Godrej & Boyce*[2] while dealing with the expression 'managerial service' held that "Generally, managerial services must necessarily be non-technical services."

It would be appropriate to refer to the observations made in the ruling of the *AAR in Re P.No 28 of 1999*[3], wherein the consultancy services have been differentiated with technical services. The technical services have been interpreted as services requiring expertise in a technology and consultancy services have been interpreted as advisory services. The categories of technical and consultancy services are overlapping to some extent, because a consultancy

[1] *Linde A G vs. ITO (1997) 62 ITD 330 (Mum ITAT)*
[2] *Godrej & Boyce Mfg Co Ltd vs. CIT (1993) 203 ITR 947 (Bom)*
[3] *AAR in Re P.No 28 of 1999 (1999) 242 ITR 280*

service could also be a technical service. However, the category of consultancy services also includes an advisory service, whether or not expertise in a technology is required to perform it.

The Supreme Court in the case of *GVK Industries Ltd*[4] had also placed reliance on the decision of the Delhi High Court in the case of *Bharti Cellular*[5]. The Delhi High Court, while dealing with the concept of consultancy services, held that the service of consultancy also necessarily entails human intervention and the consultant who provides the consultancy service, has to be a human being. A machine cannot be regarded as a consultant. Similarly, Delhi ITAT in the case of *Adidas*[6] held that consultancy is generally understood to mean an advisory service. However, not all kinds of advisory could qualify as technical services and for any consultancy to be treated as a technical service, it would be necessary that a technical element is involved in such advisory. Thus, the consultancy should be rendered by someone who has special skills and expertise in rendering such advisory.

II. Legislative Background- Amendments to Section 9(1)(vii) of the Income-tax Act, 1961

The taxability of services in the nature of 'fees for technical services' was intended to be determined under the source rule of taxation. The landmark judgment of the Supreme Court (SC) in the case of *Ishikawajima*[7] is worth citing while discussing this aspect. The SC while deliberating on the issue of taxability of offshore services, ruled that Section 9(1)(vii) envisages two conditions which have to be satisfied simultaneously *viz.* services have to be rendered in India as well as be utilised in India. It was also held that merely the 'source' of income being located in India would not render sufficient nexus to tax the income from that source. Though the services have been used in India, the same have not been rendered in India and therefore, would not be taxable in India.

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The Finance Act 2007 inserted Explanation to Section 9(2) with retrospective effect from 1st June 1976 to provide that, where income is deemed to accrue or arise in India under clauses (v), (vi) and (vii) of sub-Section (1), such income shall be included in the total income of the non-resident, whether or not the non-resident has a residence or place of business or business connection in India. It is not necessary to establish territorial nexus between the incomes deemed to accrue or arise to the non-resident in the territory of India.

The view expressed by the SC in *Ishikawajma* (*supra),* was also relied upon by the Bombay High Court in the case of *Clifford Chance*[8]. The HC stated that only income from services which are rendered and utilised in India should be taxable in India and since the lawyers of the assessee firm rendered services outside India also, only income charged on hourly basis and utilised in India would be chargeable to income tax.

The Karnataka High Court in the case of *Jindal Thermal*[9] advocated a similar view after analysing the technical services carried on offshore and held that the criterion of residence, place of business or business connection of a non-resident in India has been done away with for fastening tax liability by incorporating Explanation in Section 9(2). However, the criterion of rendering service in India and the utilisation of the service in India laid down by the Supreme Court in *Ishikawajma's* case to attract tax liability u/s 9(1)(vii) remains untouched and unaffected by the amendment to explanation to Section 9(2) by the Finance Act 2007.

Pursuant to the judgment of the Karnataka High Court, the Explanation to Section 9(2) was amended by the Finance Act 2010 w.r.e.f. 1976. The Memorandum to the Finance Bill 2010, expressly stated that it had never been the intent of the legislature that *situs* of rendering of services is not relevant as long as the services are utilised in India and therefore, in order to remove the doubts persisting about the legislative intent of the source rule, the explanation is amended so as to include income

[4] *GVK Industries Ltd vs. Income Tax Officer [2015] 54 Taxmann 347 (SC)*
[5] *CIT vs. Bharti Cellular Limited (2009 319 ITR 139)*
[6] *Adidas Sourcing Ltd. vs. Asst DIT (2012 28 taxman 267 Del ITAT)*
[7] *Ishikawajima Hajima Heavy Industries Ltd. vs. DIT (2007 288 ITR 408)*
[8] *Clifford Chance vs. DCIT (2008) (176 taxman 458) (Bom)*
[9] *Jindal Thermal Power Company vs. DCIT (2009)(182 taxman 252) (Kar)*

The Apex Court observed that the 'source rule' of taxation seeks to tax income in the country from which income is economically produced, *i.e.* the country where the business activity is wholly or partly performed or where commercial need for the product originates.

of a non-resident within the deeming provisions whether or not the non-resident has residence or place of business or business connection or has rendered services in India. In other words, service shall become taxable in India regardless of the place where it is performed and utilised.

In view of the aforementioned amendments, it is evident that the condition of 'rendering services in India' for establishing the territorial nexus is no longer required to tax the services in India under the source rule. The amendment has enlarged the scope of taxation for FTS in India. Moreover, the amendments made by the Finance Act, 2010 have nullified the decision of the Hon'ble Supreme Court in the case of *Ishikawajma* (*supra*) as well as the decision of the Hon'ble Karnataka High Court in the case of *Jindal Thermal Power* (*supra*).

III. GVK's Case

The Division Bench of the Supreme Court has recently pronounced a ruling dated 18th February, 2015 on whether financial advisory consultancy services rendered by a non-resident to GVK Industries falls within the ambit of Section 9(1)(vii) of the Act. The facts of the case and the decision of the Supreme Court have been discussed in the ensuing paragraphs of this article.

1. Facts of the Case

- The taxpayer (GVK industries Ltd.) is a company engaged in setting up a 235 MW gas based power project. It sought services of a consultant *viz.* ABB Projects & Trade Finance International Ltd, Zurich (hereafter referred to as 'NRC') for raising funds from India and abroad.
- The scope of services offered by NRC included:
  a. Developing a comprehensive financial model to tie up the rupee/foreign currency loan requirements.
  b. Assessing export credit agencies worldwide and obtaining commercial support on the most competitive terms.
  c. Assisting the taxpayer in loan negotiation and documentation.
- The success fee agreed upon between the taxpayer and NRC was 0.75% of the total debt financing. The taxpayer applied for a 'No Objection Certificate' (NOC) to remit the amount to NRC.
- The Income Tax Officer refused to issue the NOC. Subsequently, the taxpayer preferred a revision petition before Commissioner of Income Tax (CIT). Initially, the CIT permitted the taxpayer to remit the sum without deduction of tax and required the assessee to furnish a bank guarantee for the amount of tax. However, subsequently, CIT revoked its earlier order and directed the taxpayer to deduct tax from payments made to NRC.
- Thereupon, the taxpayer filed a writ petition before the High Court.

2. Revenue's Contention

- NRC was appointed not only to arrange for the loan, but also to render several other financial and general services and also involved itself in public issue of the company which would fall within the ambit of both managerial as well as consultancy services liable to tax u/s 9(1)(vii)(b) of the Act.
- There was business connection between NRC and the taxpayer which was evident from the voluminous transactions between the two and, therefore, would fall within the ambit of Section 9(1)(i) of the Act.
- Services rendered were a regular matter as NRC played a role not only for getting loan but also for further participation in business activity which was clearly evincible from the correspondences made.
- The services by NRC were rendered within India and therefore tax was required to be deducted before remitting the success fee to NRC.

3. Taxpayer's Contention

- NRC did not have any office or establishment in India and the services of NRC were rendered outside India and therefore, no part of the fee could be said to have accrued or arisen in India.

- There was no business connection in India, therefore the provisions of Section 9(1)(i) was not attracted.
- NRC did not render any technical or consultancy service to the taxpayer but only rendered advise in connection with fund raising activity by it and therefore, would not fall within the ambit of Section 9(1)(vii)(b) of the Act.
- Merely because the amount of success fee was paid to NRC in India for services rendered outside India, the income could not be deemed to accrue or arise in India.

4. High Court's Ruling

- Amount paid by the taxpayer to NRC as success fee would not be taxable in terms of Section 9(1)(i) of the Act, as the transaction/activity did not have a business connection.
- Advice given to procure loan to strengthen finances may come within the compartment of technical or consultancy service and therefore, success fee would fall within the scope of Section 9(1)(vii)(b). Hence, the taxpayer was not entitled to No Objection Certificate (NOC).

5. Supreme Court's Ruling

A. Business Connection:

- The Supreme Court, concurred with the view of the High Court that amount paid to NRC would not be taxable in terms of Section 9(1)(i) of the Act placing reliance on the principles laid down by the Apex Court in the case of R. D. Aggarwal[10], TRC[11] and Barendra Prosad Ray[12], held that the amount paid by the taxpayer to NRC as success fee would not be taxable under Section 9(1)(i) of the Act as the transaction/activity did not have any business connection.
- The Apex Court observed that Revenue had not advanced a case that income had actually arisen or received by NRC in India.

B. Source Rule Taxation

- The Apex Court observed that the 'source rule' of taxation seeks to tax income in the country from which income is economically produced, *i.e.*, the country where the business activity is wholly or partly performed or where commercial need for the product originates.
- It has been specifically stated in the judgment that the taxpayer had not invoked the India-Swiss Confederation Treaty and therefore, the taxability of the success fee is determined in accordance with the provisions of the Act.
- Section 9(1)(vii)(b) sets down the principle what is basically known as the 'source rule', that is, income of the recipient to be charged or chargeable in the country where the source of payment is located, in other words where the payer is located. The clause further mandates and necessitates that the services should be utilised in India.
- The principle 'Residence State Taxation' gives primacy to the country of residency of the assessee. This principle postulates taxation of world-wide income and world-wide capital in the country of residence of natural or juridical person. The residence rule is perceived to benefit the developed countries.
- The 'Source State Taxation' rule confers primacy to right to tax to a particular income or transaction to the state/nation where the source of the said income is located. The source rule is transaction specific and is also termed as territorial principle. It is regarded as more beneficial to the developing nations.
- As per the principle of nexus, the nexus of the right to tax is in the source rule. It is founded on the right of a country to tax the income earned from a source located in the said state irrespective of the country of residence of the recipient. The source based taxation is accepted and applied in international tax law.
- This principle of formal territoriality applies in particular, to acts intended

Based on the factual matrix of the case, the Apex Court held that NRC had the requisite skill, acumen and knowledge in the specialised field and certainly acted as a consultant.

[10] *iCIT vs. R. D. Aggarwal and Co(1965 56 ITR 20 SC)*
[11] *CIT vs. TRC (1987 166 ITR 1993 SC)*
[12] *Barendra Prosad Ray vs. ITO (1981 129 ITR 295 SC)*

to enforce internal legal provisions abroad.[13] Therefore, deduction of tax at source when made applicable, it has to be ensured that this principle is not violated.

C. Success Fee as FTS

- Explanation 2 to Section 9(1) (vii) defines "fees for technical services" to mean any consideration for rendering of any managerial, technical or consultancy services. The expression, managerial, technical or consultancy services, has not been defined in the Act and therefore, it is obligatory to examine how the said expression is used and understood by the persons engaged commercially.
- The Apex court referred to the decision of *Bharti Cellular Ltd* (*supra*), where the Delhi High Court observed that consultant has been defined as a person who gives professional advice or services in a specialised field. Moreover, the service of consultancy necessarily entails human intervention.
- The Apex Court referred to the Blacks Law Dictionary, wherein the term 'consultancy' has been defined as an act of asking the advice or opinion of someone. It means a meeting in which a party consults or confers and eventually it results in human interaction that leads to rendering of advice.
- Based on the factual matrix of the case, the Apex Court held that NRC had the requisite skill, acumen and knowledge in the specialised field and certainly acted as a consultant. The nature of services rendered by NRC would certainly come within the ambit of the term 'consultancy service' and therefore, it has been rightly held by the High Court that the amount paid as success fee would be classified as FTS and tax should have been deducted at source.

IV. Our Analysis

The Supreme Court, while determining the taxability of services has clarified the meaning of consultancy services and deliberated on the concept of the source rule as well. It may be pertinent to note that the decision has been rendered while considering the provisions of the Act only. The readers may note that the definition of FTS in the treaty may be similar to the definition as provided in the Act. However, some treaties have additional restricted covenant such as 'make available' clause, which makes the applicability narrower and may, therefore, result in restricting the right of the source country to bring the same to tax. It is, therefore, important to note that the scope of taxability of FTS in the source state is curtailed down if the provisions of the DTAA are invoked.

Provisions of the Act and the DTAA shall have to be seen holistically to determine the taxability of such transactions.

The Supreme Court has also explained as to how the 'Source Rule' has developed over the years and how such rules endeavour to curtail the possibility of double taxation. Another important aspect which has been delved upon by the Court is that the Source rule is in consonance with the nexus theory and does not fall foul of the said doctrine on the ground of extra-territorial operation. The decision of the Constitution Bench of the Apex Court in the case of the *GVK*[14] was also relied upon wherein the constitutional validity of the provision of Section 9(1)(vii) was upheld. The 'doctrine of nexus' for determining the jurisdiction of income of non-residents has been an integral part of the Indian tax charter. Even in the context of international taxation, it has emerged as a fundamental norm and has been an accepted principle in the UN Commentaries as well as the Organisation of Economic Development (OECD) Commentaries.

Provisions of the Act and the DTAA shall have to be seen holistically to determine the taxability of such transactions. The ruling needs to be cautiously relied upon keeping into consideration the fact that the Supreme Court has itself expressly stated that since the taxpayer had not invoked the Double Taxation Avoidance Agreement between India and Switzerland, the taxability of success fee has been examined in terms of the provisions of Section 9(1)(vii) of the Act only. The taxpayers as well as the Revenue authorities should therefore, see the ratio of the decision in terms of the facts of the case before applying the same universally to all cases encompassing the taxability of consultancy services. ■

[13] *Klaus Vogel on Double Taxation Convention, South Asean, Reprint Edition (2007)*
[14] *GVK Industries Ltd vs. ITO [2011] 332 ITR 130 (SC)*