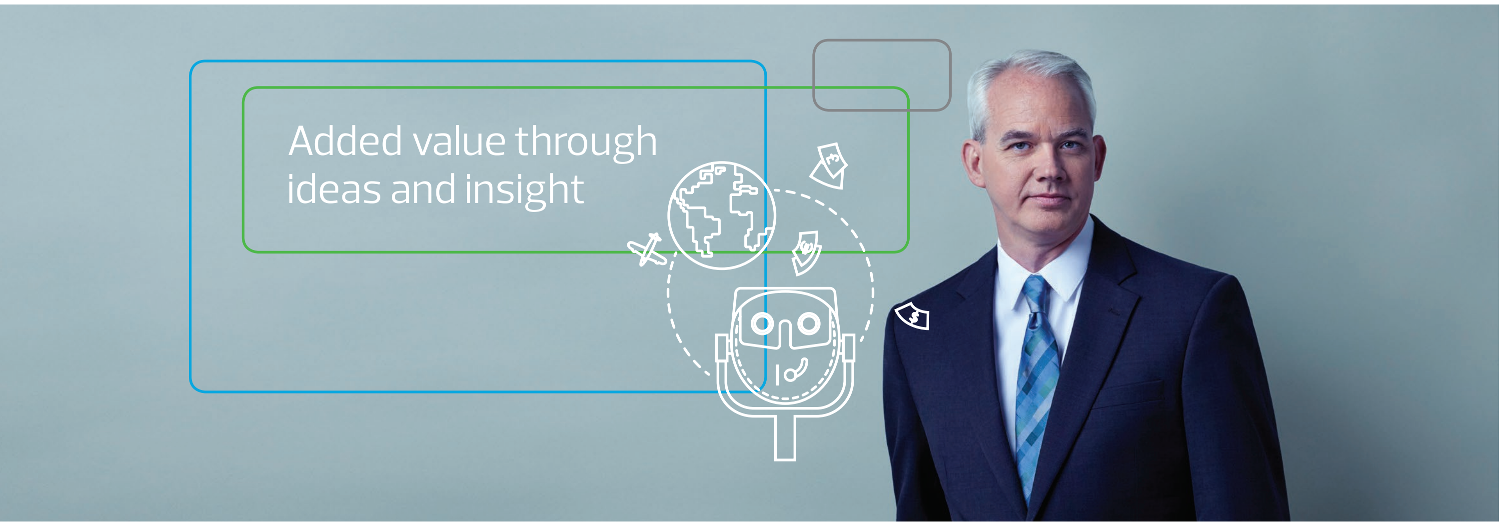

TAX INSIGHT: Tech Mahindra Limited – An equine trilogy

When you are on a good thing, stick to it – never look a gift horse in the mouth and never change horses in mid-stream.

The Full Federal Court has affirmed the first instance decision that fees paid by Australian customers to an Indian company for the provision of certain 'technical services' constituted royalties. The appellate court also affirmed the trial judge's conclusion that the royalties were not 'effectively connected' with the Indian company's Australian permanent establishment. The payments were, therefore, subject to Australian royalty withholding tax rather than being taxed as business profits under the normal assessing provisions.

The decision is one of those curios that appear from time to time. It is another international case which further develops Australia's international tax law, which is to be welcomed as the world's international tax framework stands on the cusp of fundamental reform. On the other hand, certain features of the case – an 'old' double tax agreement provision; an optimistic taxpayer forced to reverse position; the ATO similarly reversing its position; and provisions inserted into the treaty for the benefit of India, which appear to have been applied against the Indian company - raise questions about how wide will be the impact of the decision in practice. **At the very least, every off-shore company delivering services into Australia via a permanent establishment, with support provided from off-shore, must ensure the Australian income should be returned through the Australian tax return, and that it should not be subject to royalty withholding tax.** (This issue is developed below, in considering the decision's 'Broader Implications'.)

THE FACTS

Tech Mahindra Limited (TML) is an Indian technology company that provides outsourced technical services in the computer and information technology areas. The relevant year of income was 30 June 2008. For that year, TML was registered with ASIC as a foreign company carrying on business in Australia, and it lodged an Australian company income tax return reporting the taxable income of an Australian permanent establishment (TML PE).

During the 2008 year, TML had 69 Australian customers. It serviced these through its Australian offices (821 employees based in Melbourne and Sydney) or through its Indian employees (many thousands, based in Hyderabad). A distinction was drawn between services provided by the Australian employees (Australian Services) and those provided by the Indian employees from India (Indian Services). Income for the Australian Services was taxable in Australia. In dispute was the application of Australian tax law to the income from the Indian Services.

When TML prepared and lodged its 2008 Australian PE tax return, it included all the revenue received from its Australian customers, i.e. for both the Australian Services and the Indian Services, but claimed a tax deduction for the payment to TML India for the provision of the Indian Services. This approach resulted in Australian company tax at 30% being paid on the profit margin of the Indian Services.

Subsequently, TML objected against its own self-assessed position, arguing the Indian Services revenue should not be subject to Australian tax. The deduction for the payments to TML India were also reversed, thus removing the Indian Services profit margin from Australian tax.

The ATO denied the objection on the primary ground that the Indian Services revenue was assessable income, but if not, then the gross revenue was subject to 15% royalty withholding tax (RWT). (Whilst not immediately clear, the figures in the reported decisions indicate the royalty withholding tax would be a significantly larger figure than the company tax payable on the Indian Services profit margin.)

THE AUSTRALIA-INDIA DOUBLE TAX AGREEMENT – 1991

The double tax agreement (DTA) between Australia and India contains certain features which reflect positions in agreements negotiated between a developed country and a developing country. One of these features is the inclusion in Article 7(1) of a limited 'force of attraction' provision, which extends a country's taxing right over business profits. Therefore, under the DTA, Australia could tax business profits if they were 'attributable':

a. to TML's Australian PE (standard nexus)

b. to business activities of the same or a similar kind as those carried on, through TML's Australian PE (extended or deemed nexus)

The ATO position was that the Indian Services were subject to Australian tax as business profits, but only by virtue of Art. 7(1)(b) – the extended or deemed nexus provision – and not under the standard nexus provision in Art. 7(1)(a). If the ATO was incorrect in this primary argument and the Indian Services profit was not assessable as business profits under Art. 7, then it would subject the gross revenue to royalty withholding tax.

REVERSAL OF POSITIONS

In adopting this view on the application of the business profits Article, the ATO compounded TML's error in disturbing the original assessment. By the time the matter came to court, both parties had reversed their initial positions and were arguing for the contrary. Very confusing.

Faced with the prospect of royalty withholding tax applying to the gross payments, TML argued:

> The Indian Services payments were royalties – but the Indian Services were 'effectively connected' with the TML Australian PE – so the payments should be taxed as business profits and not subject to royalty withholding tax.

If successful in its argument to this point, TML would have returned to its original tax return position, and dodged a nasty RWT 'bullet' in the process.

TML went on to argue that the Indian Services were not subject to Australian tax under (1)(b) so they should escape Australian tax altogether. (If successful on this extended point, TML would have achieved the position it expected when it objected against the tax return as originally lodged.)

Interaction between the business profits and royalty Articles

Article 12(4) is a 'tiebreak' provision dealing with situations where a payment falls within both the definition of business profits (dealt with under Art. 7) and also within the definition of royalties (dealt with under Art. 12). In the overlap case, royalty treatment will prevail unless the underlying services giving rise to the payments are 'effectively connected' with the TML Australian PE. Where there is such an 'effective connection', Art. 7 (business profits) will take precedence and the profit will be taxed at 30%. Royalty treatment under Art. 12 will not apply.

TML argued that the test of 'effective connection' was satisfied irrespective of whether the Indian Services income was attributable to the TML Australian PE by virtue of the standard nexus – under (1)(a) – or by virtue of the extended nexus – (1)(b).

The ATO took the opposite position, thus reversing its own reasoning from the objection decision. The ATO now argued that the requirement for 'effective connection' was satisfied only where the Indian Services income was directly attributable to the PE by virtue of the standard nexus – (1)(a) – and not in circumstances where the income was only attributable through the extended nexus provision of (1)(b).

At the trial hearing, it was common ground between the parties that profits from the Indian Services were not attributable to TML's Australian PE, and that Australia did not have taxing rights in respect of that profit, under Art. 7(1)(a). Whilst a tactically clever move on the part of the ATO, this agreed position casts doubt on the general application of the decision. The ATO strategy was clear – it had already been agreed that (1)(a) did not apply on the facts, so the ATO had only to convince the judge that the extended deeming provision under (1)(b) was insufficient to satisfy the 'effectively connected' test, in which case the Indian Services revenue would continue to be taxed as a royalty.

TML advanced an alternative argument: if the payments were subject to tax as business profits under Art. 7, then the income would not be assessable in any event because the Indian Services were performed in India, and Australia, therefore, had no taxing right. (This argument was based on the wording in Art. 7(1)(b) above.)

Were the payments 'royalties'?

Given the centrality of the concept of royalty to the decision, one may have thought the reasons would have opened by addressing this issue. But instead, it was the last of the major issues to be addressed. And as with the other issues, it was hotly contested.

As a general rule, Australia follows the OECD distinction between payments which are royalties (income from letting existing knowledge) and payments which are for the provision of services (business profits, not royalties). But the Indian DTA incorporates another UN position which aims to assist developing countries – the definition of 'royalty' is extended (under Art. 12(3)(g)) to include the provision of certain technical services where those services:

- 'make available' (existing) technical knowledge, experience, skill, know-how or processes
- consist of the 'development and transfer' of a technical plan or design

TML argued that neither of these requirements were satisfied in the circumstances so that payments of the Indian Services could not fall within the definition of 'royalty'. The ATO position was to the contrary.

DECISION OF PERRY J AT FIRST INSTANCE

On the royalty definition issue

The Indian Services did not 'make available' any existing knowledge in the relevant sense, however, most of the Indian Services did result in the 'development and transfer' of a technical plan or design; specifically, the computer software that was created through the work of the Indian employees.

Her Honour analysed the 9 components of the Indian Services and concluded the payments relating to most were royalties as defined.

Royalties or business profits? The Art. 12(4) issue
Her Honour held that the Indian Services would be 'effectively connected' with the TML Australian PE only where the income was attributable under the standard nexus in (1)(a); nexus through the extended deemed 'force of attraction' option in (1)(b) was insufficient to satisfy the requirement. As the parties had already agreed that (1)(a) did not apply in the circumstances, there was no scope for Art. 7 to operate.

CONCLUSION

TML lost on the royalty definition issue: the payment for most of the Indian Services were held to be 'royalties'.

TML lost on the business profits (Art. 12(4)) issue: the Indian services were not 'effectively connected' with the TML Australian PE, so were not taxed as business profits (at 30% on the profit) but as royalties (at 15% of the gross revenue).

Perry J did find for TML on the alternative issue – if she was in error and Art. 7 should prevail, then the Indian Services should not fall within Australia's taxing rights.

FULL FEDERAL COURT DECISION

In a succinct joint judgement, the Full Court upheld the trial judge's conclusion on the application of Art. 12(4) - which was the only issue on appeal. The reasons of the Full Court conclude "... the primary judge was correct on the construction and application of Art. 12(4)."

The case cannot go any further without the High Court granting special leave to appeal. In the circumstances, it is suggested this is an inappropriate case to take forward. However, there certainly are issues in the decisions which have a broader interest, although perhaps they are explicable on the basis of the way the matter was argued.

BROADER IMPLICATIONS

What does the decision mean in practice?

Business profits nexus
The case decided two things. First, payments for the Indian Services were royalties, under the extended definition of 'royalty' in the India DTA. Second, a royalty payment will only be 'effectively connected' to a PE where the services giving rise to the royalty payment are 'attributable' to the PE under the standard nexus rule, not the extended nexus rule. In reaching its objection decision, the ATO concluded (presumably based on an understanding of the facts) that Australia's taxing rights over the Indian Services income could only be supported under the extended nexus rule. The ATO view was that the Indian Services income was not 'attributable' to TML's Australian PE under the standard nexus rule.

With effect from 2013, the extended nexus rule was removed from the India DTA, leaving only the standard nexus rule to operate. What implications might that have if the case was to be re-run now? At the legal theory level, there would be no change: Her Honour's decision found 'effective connection' links to the standard nexus rule, not the extended nexus rule. As the standard nexus rule remains (now alone) there is no change to the jurisprudence. But it is the TML facts, and the ATO's view of them in particular, which is troublesome

Perry J set out in some detail the contractual and practical arrangements which existed between TML and the Australian customers. Whilst it is clear that TML, the Indian company, was the 'other' legal party to the Australian Customer contracts, the better analysis on the facts would characterise those contracts as assets which should have been attributed to the TML Australian PE. Had that view prevailed, the gross revenue from the Australian customers would have been returned in the TML Australian PE tax return, with a tax deduction claimed for payments back to India for the provision of the Indian Services. In other words, the position originally adopted in the 2008 TML PE tax return.

This was not the conclusion drawn by the ATO in its objection decision. So, if the case was to be re-run today under the current Art. 7 of the India DTA, the factors which should remain the same are the facts, and the ATO reasoning underlying its original objection decision. On that reasoning, the ATO would conclude the Indian Services income are still not attributable to the TML Australian PE under the standard nexus rule, and in the absence of the extended nexus rule, must be treated as a royalty and subject to Australian royalty withholding tax.

This is clearly a risk which exists under the current India DTA, and any other of Australia's DTAs which include technical services within an extended definition of 'royalty'.

All off-shore companies which operate into Australia in a similar manner to TML must review their circumstances to confirm their Australian sourced income is being correctly treated as subject to Australian tax on a net basis as business profits, rather than subject to Australian royalty withholding tax on a gross basis.

Australian companies making payments to any off-shore providers of technical services will have to review their arrangements and ensure the payments can safely be treated as business profits (of the off-shore company) and that they are not royalties, which would place a withholding obligation on the Australian customer/payer.

As a completely separate issue, there is the question of how foreign Revenue Authorities might react if the ATO was to adopt this 'royalty over business profits' approach. These issues are beyond the scope of this case note, but companies should appreciate they are 'live' matters which need to be addressed in the proper management of a taxpayer's Australian tax obligations.