TAX **INSIGHT**

SATYAM COMPUTER SERVICES V ATO: ROUND 2 – INTERNATIONAL TAX WAR INTENSIFIES AND CORPORATE DOUBLE TAXATION?

Satyam Computer Services has returned to the Australian Courts to again contest Australia's taxing rights over fees paid by Australian customers for IT/technical services performed by Satyam employees based in India. Generally, service fee income is taxed in the State where the work is performed, but a provision in the Australia/India double tax treaty characterises the income as a 'royalty' which gives Australia taxing rights.

Australian businesses paying fees to foreign service providers for technical services will need to check that no element of the payment constitutes a 'royalty'.

The Australian customer has an obligation to deduct royalty withholding tax (RWT) from the gross payment and remit that to the ATO. Penalties apply for failure to correctly characterise the payment as a royalty and to withhold and remit RWT.

This round 2 litigation raised an important international tax question: could a provision in a double tax treaty (Treaty) impose taxation where the domestic tax law, operating alone, would not?

The Full Federal Court did not have to decide this point, as it explained the correct interpretation of the domestic tax law incorporated the relevant Treaty provision, and thus there was no conflict.

We wait with interest to see whether this decision marks the end of the litigation, or whether Satyam Computer Services will seek special leave to take the matter to the High Court. Based on the facts and the Federal Court reasoning, it seems unlikely special leave would be granted.

Given current developments in international tax law (independent of this case), and the commercial and political implications of the current case, it is to be hoped the High Court will take the opportunity to add its precedential views to the relevant international jurisprudence.

WHO IS THE TAXPAYER: SATYAM COMPUTER SERVICES OR TECH MAHINDRA?

The two Indian companies were amalgamated in 2013. The round 1 litigation was commenced in the name of Satyam (which lodged the disputed 2008 Australian permanent establishment (PE) tax return) but the name changed during the hearings, and the round 1 decisions are in the name of Tech Mahindra.

THE ISSUE IN DISPUTE

This round 2 litigation covers the 2009–2011 tax returns; and has been instigated in the name of Satyam.

In the 2008 litigation, the substantive issue was the same as in this round 2 litigation:

> Does Australia have taxing rights over income paid by Australian customers to Satyam (a company resident in India for tax purposes) for IT and technical services which were provided by Satyam employees who are physically based in and working from India ('Indian services income').

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At first instance in the round 1 litigation, Perry J held that the Indian services income was not taxable in Australia as business profits, as it was not attributable to Satyam's Australian PE, and by implication did not have an Australian source under ordinary conceptions.

Her Honour also held that some of the Indian services income came within the Article 12 Treaty definition of royalty; was therefore deemed to have an Australian source under Treaty Article 23; and was liable to tax in Australia, by way of RWT.

On the round 1 appeal the only issue in dispute was the trial judge's holdings on the interaction between Treaty Article 7 (business profits) and Article 12 (royalties). Her Honour's views on the source of the Indian services income (i.e. Treaty Article 23) was not subject to appeal. The Full Federal Court upheld the trial decision.

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Special leave to appeal to the High Court was refused.

ARTICLE 23 VS DOMESTIC TAX LAW: CONFLICTING SOURCE RULES?

This round 2 litigation addresses the issue which was 'missed' in the round 1 appeal – the apparent conflict between the scope of 'source' under Australia's domestic tax law, and under Treaty Article 23.

Under Australia's domestic tax law, and in line with general international conceptions, the 'source' of services income is where the work done to generate the income is performed. In this case, the relevant work is performed in India and thus has an Indian 'source' under Australian domestic tax law. So much was implicit in Her Honour's holding that the Indian services income was not 'attributable to' Satyam's Australian PE.

But where the Treaty allocates taxing rights to a particular country – in this case, because some of the Indian services income was a royalty under Article 12, taxing rights were allocated to Australia – then for Treaty purposes Article 23 will deem that income to have an Australian source.

That was the case in the Satyam litigation.

SATYAM'S ROUND 2 CONTENTIONS

Satyam argued that there was a conflict about the scope of the application of 'source'; Treaty Article 23 went further than the domestic law. It argues (in several different ways) that Treaty provisions cannot impose a tax liability which is not otherwise provided for under domestic tax law. A Treaty 'allocates' taxing rights between States, but it is up to the domestic law of each State to collect the tax. A Treaty operates ''only as a shield, and not as a sword''.

In short, according to Satyam, whilst the Treaty allocated source rights to Australia pursuant to Article 23, because the income did not have an Australian source under Australia's domestic law, Australia could not tax the income.

FULL FEDERAL COURT DECISION

The matter came on as a 'case stated' for determination by a Full Bench of the Federal Court, comprising the 3 Justices who sat on the round 1 appeal – Robertson, Davies and Wigney JJ.

In a tightly reasoned single judgement, focused on the principles of statutory construction, the Court held there was no conflict of source as argued by Satyam. The Indian Treaty is incorporated into Australian domestic tax law by the International Tax Agreements Act (Agreements Act). The Income Tax Assessment Act (Assessment Act) is incorporated into and to be read as one with the Agreements Act. Thus, within Australian domestic tax law there are two concepts of source – the first according to Article 23 of the Indian Treaty, and the second according to the Assessment Act sec. 995-1 definition. In this instance Article 23 is the 'leading provision', and the sec. 995-1 definition is the 'subordinate provision'. The subordinate provision must give way – so the Article 23 conception of source prevails and is the applicable definition for Australia domestic tax law purposes.

Satyam relied on a number of Indian court decisions which ''...recognised that a provision of a double tax agreement cannot fasten a tax liability where the liability is not otherwise imposed by a local Act.'' These decisions were not considered at odds with the Federal Court's reasoning, as in the Court's view it was not the operation of Article 23 as part of the Treaty which imposed the taxing right, but rather Article 23 operating as part of Australia's domestic tax law which gave Australia the taxing right.

Satyam is now running 0-4 in the Australian Courts; we wait to see whether the company wants to have one last attempt, or whether perhaps it will seek another forum.

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PROTOCOL TO THE INDIAN TREATY

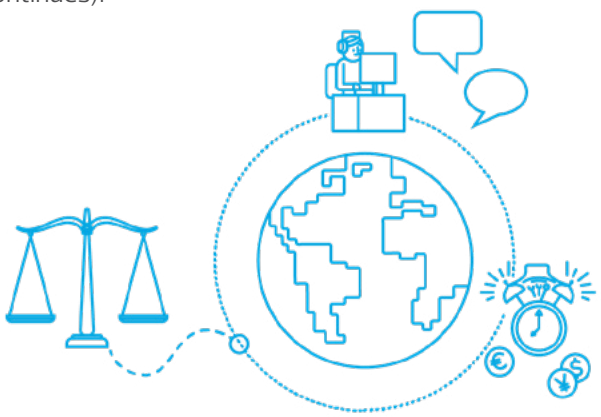
The 1st and 2nd round litigation has covered the 2008–2011 Australian income years. A protocol to the Indian Treaty came into effect from 2013 – how might that impact Satyam in subsequent years?

In short, not at all. The protocol made a number of amendments to the Treaty but did not disturb Article 12 on royalties. It is the inclusion in the Article 12 definition of royalty of the 'technical services' extension (consistent with the UN Model Tax Convention for developing countries) which (ironically) has operated against Satyam and in favour of Australia (apparently a 'developed' country).

Satyam's Indian services income will continue to be subject to Australian RWT into the future until:

- The Article 12 definition is changed to exclude the 'technical services' extension; or
- Satyam changes its service delivery to extract more of its Indian-based activities from the extended definition of royalty.

In the meantime, we can expect Satyam (and any similarly structured Indian resident IT/service providers) to continue to be subject to unrelieved double taxation, to a greater or lesser degree (which is why, one assumes, this litigation continues).



IF SPECIAL LEAVE IS SOUGHT...?

What might the High Court do if Satyam lodges a special leave application?

The Federal Court reasoning and decision appears, with respect, solid. It would be easy for the High Court to repeat the sentiment of the round 1 refusal:

> "We are not persuaded that there is any reason to doubt the correctness of the construction of the Treaty adopted [and its interaction with Australian domestic tax law] [by the Full Federal Court] and we are not persuaded that there is, in substance any conflict between that decision and the [unnamed] decision of the Supreme Court of India, to which reference has been made. In those circumstances, special leave to appeal is refused with costs."

However, the tax world has moved on significantly in the last 18 months and is clearly heading into an extended period of conflict between sovereign States where corporate double taxation (in all its various manifestations) will be the new norm.

Against this background, a High Court decision on the important issue of the interaction of tax treaties with Australian domestic tax law will be most welcome.

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