Financial advisory services provided by a non-resident treated as 'consultancy service' taxable as Fees for Technical Services – the Supreme Court

26 February 2015

Background

Recently, the Supreme Court of India in the case of GVK Industries Ltd.[1] (the taxpayer) has held that the services provided by a non-resident company as a financial advisor to an Indian company are consulting in nature. The non-resident financial advisor had provided services with respect to preparation of a scheme for raising the required finance and tie-up loans for the power project. The non-resident company had the skill, acumen and knowledge in the specialised field to provide such services. Therefore, such services have been held to be taxable as Fees for Technical Services (FTS) under the Income-tax Act, 1961 (the Act).

The Supreme Court observed that 'source state taxation' rule confers primacy to right to tax a particular income or transaction to the state/nation where the source of the said income is located. The doctrine of source rule explains that where business activity is wholly or partly performed is the source state. As a logical corollary, the state concept would also justifiably include the country where the commercial need for the product originated, i.e. where the consultancy is utilised (which in the present case is India).

[1] GVK Industries Ltd. v. Income-tax Officer [2015] 54 taxmann.com 347 (SC)

Facts of the case

- The taxpayer is a company incorporated to set up a gas based power project in Andhra Pradesh, whose main object is to generate and sell electricity.

- The taxpayer entered into an agreement with ABB – Projects & Trade Finance International Ltd., Zurich, Switzerland, (Non-Resident Company/NRC) to seek services from the financial advisor in preparation of a scheme for raising the required finance and tie up for the required loan.

- The services included, *inter alia*, financial structure and security package to be offered to the lender, making an assessment of export credit agencies world-wide and obtaining commercial bank support on the most competitive terms, assisting the taxpayer's loan negotiations and documentation with lenders and structuring, negotiating and closing the financing for the project in a coordinated and expeditious manner.

- As consideration for these services, the NRC was to be paid a 'success fee' at the rate of 0.75 per cent of the total debt financing. The NRC rendered professional services from Zurich by correspondence as to how to execute the document

for sanction of a loan by financial institutions within and outside the country.

- With advice of the NRC the taxpayer approached the Indian financial institutions with the Industrial Development Bank of India (IDBI) acting as the lead financier for its rupee loan requirement. For a part of its foreign currency loan requirement it approached International Finance Corporation (IFC), USA. After successful rendering of services the NRC sent an invoice to the taxpayer for payment of the success fee amount.

- The taxpayer approached the concerned Income Tax Officer (ITO), for issuing a 'No Objection Certificate' (NOC) to remit the said sum. It was submitted that the NRC had no place of business in India, all the services were rendered from outside India, and no part of success fee could be said to accrue or arise or deemed to accrue or arise in India.

- Since NRC had no business connection, Section 9(1)(i) of the Act is not attracted, and further as the NRC had not rendered any technical services, Section 9(1)(vii) of the Act is also not attracted. However, the ITO refused to issue the NOC.

- The taxpayer preferred a revision petition before the Commissioner of Income-tax (CIT), under Section 264 of the Act, where the CIT permitted the taxpayer to remit the said sum to the NRC by furnishing a bank guarantee for the amount of tax. Subsequently, the CIT revoked the earlier order and directed the taxpayer to deduct tax and pay the same to the central government as a condition precedent for issuance of the NOC.

- The taxpayer filed a writ petition before the High Court. The High Court held that a business connection between the taxpayer and NRC had not been established. However, advice given to procure a loan to strengthen finances may come within 'technical' or 'consultancy' services. 'Success fee' would thereby come within the scope of technical service within the ambit of Section 9(1)(vii)(b) of the Act. Accordingly, the taxpayer was not entitled to NOC. Relying on the case of Electrical Corporation of India Ltd.[2], the High Court dismissed the writ petition.

Supreme Court's ruling

No business connection in India

- The High Court was correct in holding that NRC does not have a place of business in India.

- The tax department had not advanced a case that the income had actually arisen or received by NRC in India.

Source rule taxation

- Since the taxpayer had not invoked the India-Switzerland tax treaty, the issue before the Supreme Court was whether the 'success fee' is FTS under Section 9(1)(vii) of the Act.

- Section 9(1)(vii)(b) of the Act carves out an exception which applies in a situation when the fee is payable in respect of services utilised for business or profession carried out by an Indian payer outside India or for the purpose of making or earning of income by the Indian taxpayer i.e. the payer, for the purpose of making or earning any income from a source outside India, the same is not deemed to arise in India.

- Perusal of Section 9(1)(vii) of the Act lays down the principle which is basically known as the 'source rule', i.e. income of the recipient is to be charged or chargeable in the country where the source of payment is located, to clarify, where the payer is located. The clause further mandates and requires that the services should be utilised in India.

- The two principles, namely, 'Situs of residence' and 'Situs of source of income' have witnessed divergence and difference in the field of international taxation.

- The principle 'residence state taxation' gives primacy to the country of residency of the taxpayer. This principle postulates taxation of world-wide income and world-wide capital in the country of residence of the natural or juridical person.

- The 'source state taxation' rule confers primacy to right to tax a particular income or transaction to the state/nation where the source of the said income is located. The second rule, as is understood, is transaction specific. The aforesaid principle sometimes is given a different name, that is, the territorial principle.

- 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 taxation law.

[2] Electrical Corporation of India Ltd. v. CIT [1990] 183 ITR 43 (SC)

- Appreciated on the aforesaid principle[3], the source rule would apply where business activity is wholly or partly performed in a source state. As a logical corollary, the state concept would also justifiably include the country where the commercial need for the product originated, that is, for example, where the consultancy is utilised.

- This principle of formal territoriality applies in particular, to acts intended to enforce internal legal provisions abroad[4]. Therefore, when withholding tax related provisions are applicable, it has to be ensured that this principle is not violated.

Success Fee is chargeable as FTS

- The expression, 'managerial, technical or consultancy service,' used under Section 9(1)(vii) of the Act, has not been defined in the Act and therefore, in the given factual matrix, the general and common usage of the said words has to be understood at common parlance.

- Reference was made to the ruling of the Authority for Advance Ruling in the case of In Re. P. No. 28 of 1999[5], wherein it was held that the category of consultancy services also includes an advisory service, whether or not expertise in technology is required to perform it.

- Further, the decision of Delhi High Court in the case of Bharti Cellular Limited[6] was referred which has dealt with the concept of 'consultancy services'.

- As per the Black's Law Dictionary, Eighth Edition, the word 'consultation' has been defined as an act of asking an advice or opinion of someone (such as a lawyer). It means a meeting in which a party consults or confers and eventually it results in human interaction that leads to rendering of advice.

- NRC had the skill, acumen and knowledge in the specialised field i.e. to prepare a scheme for required finances and tie-up required loans for the project. The nature of services rendered by NRC would come within the ambit of the term 'consultancy service'.

- Therefore, it has been rightly held that the tax at source should have been deducted on the amount paid as fees and could be taxable under the head 'FTS'.

Our comments

Post liberalisation, it has been a common practice amongst Indian companies to raise funds from abroad. Accordingly, non-resident financial advisors are hired to provide services like liaising with lenders, etc.

The interpretation of the definition of FTS has been a matter of debate before the courts since a long time. The Supreme Court dealt with the term 'consultancy' and has clarified it to mean an 'advice or opinion'. The Supreme Court also dealt with the doctrine of source rule which explains that where business activity is wholly or partly performed is the source state. As a logical corollary, the state concept would also justifiably include the country where the commercial need for the product originated, i.e. where the consultancy is utilised. The decision of the Supreme Court will be binding on the lower courts, tribunals and tax authorities.

The present decision is rendered under the provisions of the Act. However, under the relevant tax treaty various benefits are available to the taxpayers for e.g. restrictive definition of FTS in terms of 'make available' clause, Most Favoured Nations (MFN) clause, etc.

[3] League of Nations, Report on Double Taxation by Bruins, Einaudi, Saligman and Sir Josiah Stan (1923)
[4] The Introduction in Klaus Vogel on Double Taxation Convention, South Asean, Reprint Edition (2007)
[5] In Re. P. No. 28 of 1999 [2009] 319 ITR 139 (AAR)
[6] CIT v. Bharti Cellular Limited and Others [2009] 319 ITR 139 (Del)

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