BEFORE THE AUTHORITY FOR ADVANCE RULINGS (INCOME TAX)
NEW DELHI
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PRESENT
Hon'ble Mr. Mr. Justice P.V. Reddi (Chairman)
Mr A. Sinha (Member)
Mr. Rao Ranvijay Singh (Member)

A.A.R. NO. 747 OF 2007

Name and Address of Applicant

WorleyParsons Services Pty. Ltd.
Level 7, 116 Miller Street, North Sydney NSW 2060, Australia

Commissioner concerned

Director of Income Tax (International Taxation-II), New Delhi

Present for the Department

Mr. Sanjeev Sharma, Addl.DIT, (Intl. Taxn), Delhi.

Present for the Applicant

Mr. Pawan Kumar, FCA, Mr. Rahul Garg, FCA

RULING

[By Hon'ble Chairman]

Facts & Agreement details

1. The applicant is a company incorporated in Australia engaged in the business of providing professional services to the energy and resource industries. Reliance Petroleum Ltd. – an Indian Company proposed to lay cross-country pipelines for transportation of hydro-carbons from Jamnagar to Bhopal and from Goa to Hyderabad. In connection therewith, the applicant was awarded contract for providing various services viz. (i) engineering and procurement services, (ii) project management services, (iii) construction advisory and commissioning advisory services. Three agreements were entered into between the applicant and Reliance during the year 2001. However, all the activities contemplated to be performed under these agreements were not carried out as the contract was terminated in the mid-way i.e. in March 2003. As far as the third agreement is concerned (construction and commissioning advisory), no services were at all performed. The Phase-I of first agreement was executed fully and only a portion of the work under the second agreement was done by the date of termination. The first

agreement under which the applicant received a substantial amount is the agreement entered into on 13th August, 2001 (effective from 14th May, 2001) styled as "Engineering and Procurement Services Agreement". Even in respect of this agreement, phase-II thereof which relates to 'detailed engineering' and balance procurement items' was either not taken up or very little work was done. The applicant states that the activities concerning basic engineering services were primarily carried out in Perth, Australia. According to the applicant, the services done in Perth account for 80% of the scope of work detailed in the agreement. The procurement functions relating to phase-I were 'essentially' performed in India, according to the applicant.

1.1. Under the Agreement, namely, "Engineering and Procurement Services Agreement", the applicant has to perform the services defined in the scope of services in Appendix I. The services broadly are engineering and procurement services. Engineering services cover basic engineering and detailed engineering. "Basic Engineering Package" has been defined to mean the basic design specifications and documents in sufficient detail to enable the detailed engineering to be commenced and completed, as more particularly described in Appendix I. Section (B) of Appendix I spells out the "Scope of work and Services". It is divided into two phases. The scope of work of phase-I covers (1) studies (techno-economic system, optimization study, hydraulic study etc.) (2) pipeline route studies (3) support during statutory approval process (typical drawings, design basis and methodologies which will help in obtaining various statutory clearances), (4) process engineering which include data sheets, line lists etc. for the complete system (5) specifications required for procurement of long lead items which include specifications for installations, testing and pre-commissioning works of pipeline, pump stations and delivery stations, (6) design basis manual of all engineering disciplines (7) Front End Engineering Design including preliminary drawings of all disciplines and bill of quantities necessary for procurement of long lead items (8) drawings including typical plans of pump stations, delivery stations etc. (9) construction planning i.e. constructability evaluation of pipeline route selected by Reliance, contracting philosophy etc. (10) all services related to procurement including technical and commercial evaluation for long lead procurement items upto ordering stage, (11) all services related to contracts including technical and commercial evaluation for construction bid packages for pipeline pump stations and delivery stations upto ordering stage. The list of long lead procurement items in phase-I is given in item (12).

1.2. The scope of work under phase-II inter alia comprises of 'detailed engineering' and services related to procurement of 'balance items'. The former services include finalization of all reports prepared in phase-I to incorporate detailed engineering and vendor-data related updates, approval for construction drawings of all disciplines of engineering including pipelines. As noted already, phase-II has not been carried out. It is seen from para 5 of Appendix I that the primary responsibility for basic engineering, detailed engineering and procurement/contract services is that of the applicant and Reliance played supportive role. Para 3 stipulates that provision should be made for 7 Reliance project Team members to be stationed at contractor's head office during phase-I and at consultant's Indian office during phase-II. It is noted in para D(1) of Art.III that between the zero day (21st May 2001) and the date of execution of the agreement, the

parties have begun discussions and analysed with respect to the overall basic engineering of the project including design criteria and other information necessary to provide the process basis for the project and the contractor (applicant) shall prepare and submit all detailed schedules, plans etc. to enable Reliance to approve the basic parameters of engineering and procurement aspects of the project.

1.3. The overall schedule and milestones are prescribed in Art.V. Inter alia it is stated therein that the basic engineering and ordering of long lead items for phase-I shall be completed before 20th October 2001.

1.4. The price and price basis is set out in Art.VII. The lump sum price is stated to be 7,980,118.00 Aus Dollars. The break-up of this amount is given as follows:

(A) Jamnagar to Bhopal pipeline- lump sum fixed price for phase-I - basic engineering and procurement services of long lead items from Perth* - 2,229,794.00 Aus Dollars.

(B) Goa to Hyderabad pipeline – same as above 1,232,994 Aus Dollars.

Art.VII also stipulates that the cost of travel to and from India, the cost of accommodation and cost of providing office and communication facilities at site shall be borne directly by Reliance in accordance with project procedures set out in Appendix V.

The payment terms are set out in Art.VIII.

1.5. Though not specifically stated in the application, it is seen from the written submissions as well as the Summary of income furnished by the applicant (vide Paper Book III), that some work relating to project management services (Phase I) was also carried out in India. In fact, it was stated so in the course of arguments. In the affidavit of Mr. Richard Brooke Smith annexed to the written submissions, it is stated that no work was carried out in respect of phase-II of the Agreement pertaining to Engineering and Procurement services and the Project Management Services. As regards the detailed engineering services, they form part of phase-II of the first Agreement as seen from Appendix 1 & 2 to the Agreement and in regard to them, there is some ambiguity in the application. There is a mention of the fact that “assistance” in detailed engineering was provided from India. Excepting this vague phraseology there is nothing else to show that a portion of detailed engineering services was performed in terms of the first Agreement.

1.6. The applicant then submits that its employees were present in India for 127 days during the financial year 2001-02 and 241 days during the next year. A chart giving the details of the names of the employees and the duration of their stay in India has been furnished. The alleged discrepancy pointed out by the Revenue between the details furnished in the application and the affidavit of Mr. R.Brooke Smith was clarified in the rejoinder statement. It is seen from the chart that the first arrival of the applicant’s employee in India was in October 2001 and he stayed for 75 days. Then, in November

2001, 4 employees stayed in India for duration of 8 days. The applicant stated that no services were rendered during the financial year 2003-04 by reason of closure of the contracts. The applicant clarified in its written submissions that Mr. Mark Vaughan acted as the project manager and that he and his team members were provided with office space in the office of the local engineering contractor of Reliance, namely, Jacobs Engineering Ltd. at Jacobs House, Andheri East, Mumbai. However, the nature of work/ or services done by the applicant's employees who stayed in Mumbai has not been indicated specifically anywhere.

1.7. Procurement Services contemplated by the Ist Phase of the Agreement relate to long lead items and the services relating to procurement of balance items pertain to phase-II.

As already noted, it is the case of the applicant that Phase-I work has been completely performed. Procurement services are listed out in Appendix-1. The establishment of detailed procurement plan by the applicant in consultation with the Reliance project team is the first task mentioned therein. Then follows the preparation of detailed procurement cycle for all major items, preparation of bidder list specific to the equipment/material, preparation of Master Purchase document, floating enquiry documents to approved global venders, receiving tenders or bids, opening technical and unpriced bids and tabulating bids status, commercial evaluation of such bids, arranging technical clarification meetings with the suppliers if required, short listing acceptable suppliers and arranging meetings with them participating in commercial negotiations and preparing final summary documents after negotiation, preparing MRP document incorporating all technical parameters of selected suppliers, issuance of purchase orders and expediting the delivery of equipment as per the P.O. delivery schedule. Coordination with Engineering Department and third party inspection agency for stage-wise final inspection at vendor's work, reviewing test results/inspection release note, checking packing list of shipment, coordinating with freight forwarding contractor, updating Reliance with progress of all P.Os (Purchase Orders) and to issue P.O. amendments after Reliance approval. The split of responsibilities between the contractor (applicant) and Reliance for the procurement services during pre-order phase, post order phase and pre-award stage are also set out in Appendix-1.

1.8. It is noteworthy that there is no break-up of price for procurement services. We have already noticed that a lump-sum fixed price for Phase-1 and a separate price for Phase-II for both the pipelines was stipulated in the "Engineering and Procurement services" Agreement.

2. We shall now advert to the 2nd Agreement. The Project Management Services Agreement was entered into on 11th October, 2001 at Mumbai, its effective date being 14th May, 2001. The description of services covered by the Agreement are given in Appendix-1 to the Agreement. In Section B of Appendix-1, the scope of work and services is set out. The items in respect of which the contractor shall have prime responsibility are stated to be: (i) Overall Project Management including preparation of functional procedure; (ii) Project Controls, progress monitoring and reporting on a weekly and monthly basis; (iii) Project Cost estimation, monitoring, control and

reporting; and (iv) Project documentation control, the major responsibilities of the Contractor to perform the above mentioned functions and to ensure compliance with project cost, Schedule, Resources and quality requirements are stated in para II of Section B. Some of them are:

Coordinating with various departments and third parties to ensure scheduled milestone dates to be are met, inter-facing management with local engineering contractor, preparation and implementation of the project execution and automation plans, forewarning and highlighting key issues and taking steps to resolve the same, maintaining and analyzing control – level schedules and data bases, ensuring implementation of quality assurance plan for all deliverables, coordinating with Reliance for their inputs, preparing close-out reports, organizing training to Reliance personnel on project management related software are some of the responsibilities of the contractor (applicant) specified in Appendix I. The services to be provided from Perth and from Bombay are also detailed in Appendix-1. As per Article V of the Agreement, the estimated completion dates for Jamnagar to Bhopal and Goa to Hyderabad pipelines stated to be 31st August and 30th November, 2002 respectively. Article VII bears the caption "reimbursable compensation". According to the said Article, Reliance shall pay to contractor compensation for the services at the man-hours, man-day rates indicated in the Chart. The man-power deployment rates for Project management services including Project control are furnished in the Chart. The designations of 12 employees starting with Project Director ending with Overseer are specified therein. The employee-wise manhours at Perth and the mandays at Mumbai and the rates are specified therein. In the course of arguments it was stated that the Project Manager, Project Control Manager, Planning Engineer and Overseer were required to be in India throughout for carrying out the services. It appears that the services under this Agreement were to be partly performed from Perth and partly from India. The applicant received a sum of 899,189 Aust.dollars under this Agreement which, like the Ist Agreement, was terminated prematurely.

Questions:

3. The applicant has sought ruling on the following questions:

Whether in terms of the contract between the applicant and Reliance and on the facts and circumstances of the case:

(a) the applicant forms a permanent establishment (PE) in India due to its nature of activities and services rendered in India under the contract with Reliance?
(b) the services rendered by applicant are in nature of 'royalty' as defined in Article 12 of the DTAA between India and Australia and are effectively connected to the above PE?
(c) If answers to (a) and (b) above are in affirmative, the provisions of Para 1 and 2 of Article 12 of the DTAA between India and Australia shall not apply to receipts of the applicant under the Reliance contract, and only so much of them as are

attributable to such PE in India are taxable in India at the rate of 20% (plus surcharge, if any) provided in section 115A of the Income-tax Act, 1961?

(d) The balance receipts of the applicant under the Reliance contract are not taxable in India?

Contentions broadly

4. It is the contention of the applicant that the amounts received by it in terms of the two agreements constitute "royalty" income, that the applicant had a PE* in India where quite a number of technical and management personnel were deployed as per the details given in the application. It is the further contention of the applicant that both the agreements under which the contracted work was performed either wholly or partly should be seen as one integrated agreement. If so viewed and even otherwise, the services/receipts being effectively connected with the permanent establishment, they go out of the purview of "royalty" provisions by virtue of Art.XII.4 of the DTAA between India and Australia and the income shall then be deemed to be business income and be dealt with in accordance with Article VII of DTAA. It is then submitted that on an application of Article VII, only that part of the profits attributable to the PE is liable to be taxed as business income under the Income Tax Act, 1961 and the balance receipts are not chargeable to tax in India. Even otherwise, it is contended that royalty payable on services rendered outside India is not liable to be taxed in India on the principle laid down by the Supreme Court in the case of **Ishikawajima Heavy Industries** (288 ITR 408) and more than 80% of the services under the 1st agreement relating to Basic Engineering etc. were done in Australia. As regards the rate of tax, the applicant submits that the rate of 20 per cent prescribed in section 115A of the Act applies.

5. The Revenue agrees that the receipts under the contract with Reliance are basically in the nature of "royalties", and that the applicant had a PE in Mumbai. The Revenue, however, differs with the applicant on the point of applicability of the exclusion clause contained in Article XII.4. First of all, it is submitted that the services performed under the first agreement mostly in Australia are not effectively connected to the PE and, therefore, the recourse to Art. VII which deals with business profits is not warranted. Article VII does not come into play at all according to the Revenue. Alternatively, it is contended that whatever receipts arise from the services performed in India shall be subjected to tax as business income in view of Art. XII.4 read with Art.VII of the DTAA, and the balance amount is liable to be taxed as 'royalty' income by applying Art. XII.2 of the DTAA read with Section 9(1)(vi)(b) of the Income-tax Act. It is submitted that the decision in **Ishikawajima** (supra) is distinguishable and does not come to the aid of the applicant.

Relevant provisions:

6. Let us now advert to the provisions in the DTAA and the Income-tax Act, 1961 (hereafter referred to as 'Act').

ARTICLE XII – 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 the other State.

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

(a) in the case of:

(i) royalties referred to in sub-paragraph (3)(b);

(ii) payments of credits for services referred to in sub-paragraph (3)(b), subject to sub-paragraphs (3)(h) to (I), that are ancillary and subsidiary to the application or enjoyment for which payment or credits are made under sub-paragraph (3)(b); or

(iii) royalties referred to in sub-paragraph (3)(f) that relate to equipment mentioned in sub-paragraph (3)(b) ;

10 per cent of the gross amount of the royalties; and

(b) in the case of other royalties:

(i) during the first 5 years of income for which this Agreement has effect:

xx xx xx xx xx xx xx ,

(ii) during all subsequent years of income: 15 per cent of the gross amount of the royalties.

3. 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:

(a) the use of , or the right to use , any copyright, patent, design or model, plan, secret formula or process, trade mark or other like property or right;

(b) the use of, or the right to use, and industrial , commercial or scientific equipment;

(c) the supply of scientific, technical, industrial or commercial knowledge or information;

(d) the rendering of any technical or consultancy services (including those of technical or other personnel) which are ancillary and subsidiary to the application or enjoyment of any property or right as is mentioned in sub-paragraph (a), or any such equipment as is mentioned in sub-paragraph(c);

xx xx xx xx xx xx xx xx

(g) the rendering of any services (including those of technical or other personnel), which make available technical knowledge, experience, skill know-how or processes or consist of the development and transfer of a technical plan or design; ……..……..

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 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 or Article 14, as the case may be, shall apply.

ARTICLE VII – 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 though 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

(b) sells within that Other Contracting State of goods or merchandise of the same or a similar kind as those sold, or other business activities of the same or a similar kind as those carried on, through that permanent establishment.

2. Subject to the provisions of paragraph (3), where an enterprise of one of the Contracting States carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make (if it) were distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment or with other enterprises with which it deals.

3. In the determination of the profits of a permanent establishment, there shall be allowed as deductions in accordance with and subject to the limitations of the law relating to tax in the Contracting State in which the permanent establishment is situated, expenses of the enterprise, being expenses which are incurred for the purposes of the business of the permanent establishment (including executive and general administrative expenses so incurred), whether incurred in the Contracting State in which the permanent establishment is situated or elsewhere.

xx xx xx xx

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

Section 9 of the Income-tax Act, 1961 (the 'Act')

9. Income deemed to accrue or arise in India.

(1) The following incomes shall be deemed to accrue or arise in India.

(i) all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or through or from any asset or source of income in India, or through the transfer of a capital asset situate in India.

Explanation: For the purposes of this clause –

(a) in the case of a business of which all the operations are not carried out in India, the income of the business deemed under this clause to accrue or arise in India shall be only such part of the income as is reasonably attributable to the operations carried out in India;
……

……

(vi) income by way of royalty payable by –

(a) the Government; or

(b) a person who is a resident, except where the royalty is payable in respect of any right, property or information used or services utilized for the purposes of a business or profession carried on by such person outside India or for the purposes of making or earning any income from any source outside India; or

(c) a person who is a non-resident, where the royalty is payable in respect of any right, property or information used or services utilized for the purposes of a business or profession carried on by such person in India or for the purposes of making or earning any income from any source in India;

……..
……
Explanation 2: For the purposes of this clause, "royalty" means consideration (including any lump sum consideration but excluding any consideration which would be the income of the recipient chargeable under the head "Capital gains") for –

(i) the transfer of all or any rights (including the granting of a license in respect of a patent, invention, model, design, secret formula or process or trade or similar property;

(ii) the imparting of any information concerning the working of, or the use of, a patent, invention, model, design, secret formula or process or trade mark or similar property;

(iv) the imparting of any information concerning technical, industrial, commercial or scientific knowledge, experience or skill;

(vi) the rendering of any services in connection with the activities referred to in [sub-clause (i) to (iv), (iva) and (v)].

(vii) income by way of fees for technical services payable by –

xx xx xx xx xx

(2) xx xx xx xx xx

*Explanation: For the removal of doubts, it is hereby declared that for the purposes of this Section, where income is deemed to accrue or arise in India under clause (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."

6.1. The fee for technical services has been separately dealt with, vide S.9(1)(vii) of the Act. In the DTAA, technical services are embraced within the definition of royalty and there is no separate provision concerning FTS.

Nature of Services

7. On an analysis of the scope of work and services under the Ist Agreement, it is clear that most of the services fall within the ambit of the latter part of clause (g) of para 3 of Art. 12, i.e. development and transfer of technical plan and design as well as clause (c) read with clause (d) i.e. rendering of consultancy and technical services which are ancillary and subsidiary to the supply of scientific, technical or commercial information/knowledge. More or less similar clauses in the definition of 'royalty' contained in Explanation 2 to Section 9(1)(vi) of the Act would be attracted. Hence, in view of the agreement of both sides that the services constitute 'royalty' income within the meaning of Art.XII.3 of DTAA as well as section 9(1)(vi) of the Income-tax Act, 1961, there is no need to discuss this aspect further.

Permanent Establishment

8. It is appropriate at this stage to refer to the definition of PE as contained in Art.V of the DTAA.

ARTICLE V – Permanent Establishment

1. For the purposes of this Agreement, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

2. The term "permanent establishment" shall include especially:

(a) a place of management, (b) a branch, (c) an office, (d) a factory (e) a workshop … …. (k) a building site or construction, installation or assembly project, or supervisory activities in connection with a site or project, where that site or project exists or those activities are carried on separately or together with other sites, projects or activities for more than 6 months.

As noticed earlier, the applicant had a fixed place of business in Mumbai at the office of local engineering contractor of Reliance i.e. Jacobs Engineering Works and it admits of no doubt that the business of the enterprise was partly carried on from there. Quite a number of employees, mostly technical personnel, stayed and attended to the work for a considerable number of days during the later part of the year 2001-02 and in 2002-03. As the construction or installation work did not take place by the date of termination of contract, it is doubtful whether the establishment of the applicant can also be brought within the scope of clause (k). In any case, in view of the common ground that the applicant maintained a permanent establishment in India for the purpose of carrying out certain functions related to the contract with Reliance, there is no need to delve further into this aspect. However, we would like to indicate at this stage that the question of nexus of PE to the first Agreement is in issue and will be discussed later.

Scheme of taxation under the Treaty (DTAA)

9. Now, let us analyse the scheme of taxation on royalties under Art.XII. The first paragraph gives power to the State of residence of the person entitled to receive royalty to tax the royalty income. Para 2 preserves the power of the State of source of royalty also to tax the royalty income subject to the ceiling of rates as provided in clauses (a) & (b). Of course, the assessee who suffers tax in one of the States will be eligible to get credit of tax paid in the other country on the same income in accordance with the Provisions of DTAA.

9.1. At this juncture, we would like to clarify one aspect. In **Ishikawajima**, at page 441 of ITR, the Supreme Court said that "the tax Treaty between India and Japan is essentially based on the OECD Model". However, it is not so. Article 12.1 of OECD MC states that "royalties arising in a contracting State and beneficially owned by a resident of the other contracting State shall be taxable only in that other State." There is no provision in Article 12 of OECD corresponding to Article 12.2 of India-Japan Treaty or India-Australia Treaty which empowers the contracting State in which the royalties arise to tax such income. Thus, there is a material difference between the two provisions. The discussion in the later part of judgment would reveal that the learned judges did

recognize the power of the source country to tax the income from f.t.s* and the income arising from the operations of the permanent establishment. We find that the excerpts from OECD Model Convention given at P.441 are not correct. There are some apparent mistakes.

That is perhaps the reason why their Lordships made the observation extracted in the 1st sentence above.

9.2. Proceeding further, Para 3 of Article XII defines 'royalty'. Para 4 of the Article enjoins that the provisions of paragraphs (1) & (2) shall not apply if the beneficial owner of royalties, that is to say, the recipient of royalty income carries on business in the other contracting state in which the royalties arise (source State) through a permanent establishment situated therein and the services in respect of which the royalties are paid are effectively connected with such PE. In such an event, the provisions of Art.VII will apply. Art.VII, as already noticed, deals with taxation on business profits. If the enterprise carries on business in a contracting state through a permanent establishment situated therein, the profits are liable to be taxed in that state where the PE is situated. This is subject to the limitation that only so much of the profits as is attributable to the permanent establishment or other business activities of the same or similar kind as those carried on through that PE. In the present case, the clause relating to other business activities of similar kind is not attracted. Art. VII (2) lays down the principle for attributing profits. The profits which the PE is expected to make if it were a distinct and separate enterprise engaged in the same or similar activities – that is the test to be applied. Art.VII(3) provides that in determining of the profits attributable to a PE, the deduction of the expenses of PE shall be allowed in accordance with and subject to the income tax law governing to the State in which PE is located. Thus, the taxation under Art.XII is on a gross basis subject to the maximum prescribed rate of tax whereas the taxation under Art.VII is on net basis and the appropriate rate of tax on business income will govern.

9.3. We may also in this connection refer to Art.VII(7) on which some reliance has been placed by the Revenue. Art.VII(7) lays down that where profits include items of income that are dealt with separately in other Articles, then the provisions of those Articles shall not be affected by the provisions of this Article. The learned Counsel for the applicant is right in submitting that it shall be read in harmony with Art.XII(4) and that it does not in any way advance the case of the Revenue. In so far as the profits are inclusive of income from royalties, dividends etc. which are separately dealt with in specific Articles, those specific provisions will govern. That is the mandate of Art. VII (7). Hence, Art. XII comes into the picture as royalty is a specific item separately dealt with. Art.XII contains an exclusion clause in para (4) the effect of which is to take the income which is otherwise royalty income into the fold of business income. Art.VII(7) has no bearing on the scope and extent of exclusion contained in para (4) of Art.XII. That has to be answered on the terms of Art.XII(4) itself. A controversy in this regard is adverted to at para 15 infra.

9.4. As regards the inter-play between Art.XII and Art.VII, it would be appropriate to refer to the following passage cited by the Counsel from Mr. Philip Baker's treatise on "Double Taxation Conventions"# I

"Article 7(7): Specific articles override Article 7(1)

Article 7(7) concerns both of the situations covered by Article 7(1) (i.e. where the enterprise does or does not have a permanent establishment). Where an enterprise receives any type of income dealt with by any of the specific Articles of the Convention, the specific Articles are not affected by Article 7. Many of the other Articles-specifically Articles 10(4), 11(4), 12(3) and 21(2)-contain paragraphs which provide that, where the share holding, indebtedness, etc. is "effectively connected" with the permanent establishment, Article 7 should apply. According to paragraph 35 of the Commentary, such payments may then be regarded as "profits" of the permanent establishment within Article 7 and may be attributed to the permanent establishment or they can be taxed separately but without the limits contained in the specific Articles."

"The order of priority is thus as follows. First, it is necessary to decide whether an item of income falls within one of the specific articles-dividend, royalties etc. If it does, then that Art. applies unless the enterprise has a permanent establishment in that state and the income is effectively connected with that permanent establishment. In that event, Art.VII will apply and the income will be taxed as a profit of the permanent establishment or separately."

Analysis and applicability of Art. XII (4) of Treaty

10. Now, we shall revert back to the arguments centered on Art.XII(4). It is the contention of the applicant that the exclusion clause under Art.XII(4) is attracted in the instant case, as a result of which the applicant's income which is otherwise treated as royalty income becomes business income and be subjected to the discipline of Art.VII. Then, the entire profits cannot be taxed but only that portion of the profits attributable to the permanent establishment can be taxed. The phrase 'attributable to PE' evidently means that there must be direct correlation between the activities of PE and the income generated thereby. What is not attributable to PE cannot be taxed at all in India, according to the applicant. The learned counsel for the applicant submits that once the power of taxation under Art.XII(2) is taken away by virtue of the exclusion clause contained in Art.XII(4), nothing can be brought under the tax net of 'royalties'. The only provision available to the State of source where PE is situated is Art.VII and the quantum of profits taxable should be determined in accordance with that provision alone by applying the principle of 'attribution' and other norms governing deductions towards expenses.

11. The rationale of Art.XII(4) seems to be to tax the non-resident on the same basis as a resident of the source country i.e., on net income basis in so far as he derives profits on account of operations carried out through a fixed base or establishment maintained by him in the source country. However, the pre-requisite for attracting the exclusion clause

is that "the services in respect of which the royalties are paid are effectively connected with the permanent establishment". It must be noted that the effective connection should be between the royalty generating services and the permanent establishment. The expression 'services' is significant and should be given due weight. It is not enough that there is a permanent establishment of the non-resident in the source country carrying out some activities in connection with the project or the work. The PE may be effectively connected with the project and the contract from a broader perspective but the connection contemplated by Para 4 of Art.XII is in respect of the services that fall within the purview of royalty. The PE or fixed base set up in the source country should be engaged in the performance of royalty generating services, irrespective of what other activities it performs. Atleast, it should facilitate the performance of such services. The terminology 'effective connection' denotes a real and intimate connection. Clear co-relation between the services which give rise to royalty income and the PE is a key factor for the purpose of exclusion of paragraphs 1 & 2 of Art.XII. Prof. Klaus Vogel in his commentary on the provisions of Model Convention stated thus in the chapter dealing with "permanent establishment proviso":

"As the English and French texts of MC reveal, the term 'effectively connected with….' ('s'y rattache effectivement') should not be understood to mean the opposite of 'legally connected', but rather something in the sense of 'really connected'. Consequently, what has to be examined is whether the claim is connected with the permanent establishment not only in form, but also in substance."

11.1. The provision in the MC which is referred to in the Commentary does not specifically mention the word 'services'. The relevant provision referred to in the commentary is "the right or property giving rise to the dividends must be effectively connected with the permanent establishment or fixed base". However, the real connection test enunciated by the learned writer would equally hold good in a provision containing reference to services also.

11.2. Another key expression that has been employed in Art. XII(4) is - "carries on business through a PE". Both the expressions "carries on business" and "permanent establishment" are important and should be given their due meaning. A pragmatic and purposive approach shall be adopted in construing the said expressions. Whether or not a PE exists – factually and legally is often a subject-matter of debate, notwithstanding the definition of PE in Art.5 of various Treaties. The set up, the functions, the purpose and duration of PE are all relevant factors to be kept in mind in addressing this question. In **DIT vs. Morgan Stanley**^, the Supreme Court stressed on the functional and factual analysis of the activities of an establishment. Having thus indicated a broad test, their Lordships held:

"It is from that point of view, we are in agreement with the ruling of the AAR that in the present case article 5(1) is not applicable as the said MSAS would be performing in India only back office operations. Therefore to the extent of the above back office functions the second part of article 5(1) is not attracted."

Earlier, it was noted that MSAS an Indian Group company of the applicant (MSCO) was set up to support the office functions of MSCO in equity research and IT services.

11.3. It seems to us that the PE must be such that substantial activities pertaining to the business of the foreign enterprise must be carried out by it over a period of time. A nominal establishment with skeletal staff attending to minimal or negligible work may not be recognized as "PE through which business is carried on" within the contemplation of Art.XII(4). Otherwise, it would lead to unintended results involving tax avoidance. However, we are not saying that in this case, the PE is nominal and the activities of PE are insignificant. We are ruling out the application of Art.XII(4) on a different ground, i.e., the test of effective connection not being satisfied as far as basic engineering and procurement services are concerned.

12. Now, we have to examine the facts of the present case to ascertain whether the PE set up in India by the applicant in connection with the pipeline project work is effectively connected with the services performed by the applicant under the two agreements. Here, it must be noted that two separate agreements were entered into covering different phases of work with different rights and obligations. Though the works under the two Agreements are part of one project and contract, we have to look into the provisions and features of each agreement separately. In **Ishikiwajama** case, even a composite contract of turnkey project was held to be divisible and the various segments of contract were viewed separately by the Supreme Court. Here, the agreements, the nature of services and the consideration payable are separate and distinct. There is no overlapping between one agreement and another. On these undeniable facts, what follows? If under the first agreement i.e., the B.E.& P Services Agreement, no services were performed by the PE in India or the services performed were only negligible and the object of setting up PE was for a different purpose, then, it cannot be said that the effective connection between the services and the PE is established. As already observed, the question of effective connection should be approached from the standpoint of services falling within the scope of royalty. On a deep consideration, we are of the view that the applicant has not been able to make out the effective connection in the sense in which we have explained earlier. (vide para 11).

12.1. The case of the applicant set up in the application is that the "activities of basic engineering services were primarily carried out at Perth, Australia with a few trips to India for site visits and meetings". It is also stated that "procurement functions and assistance in detailed engineering were essentially performed in India". Then, a Chart is given showing duration of stay of employees during 2001 to 2002 and 2002 to 2003. In the course of arguments, it has been stated that as per the first agreement, more than 80 per cent of the services were carried out at Perth. The services relating to detailed engineering are part of Phase-II as noted earlier. Though the applicant stated in its written submissions filed on 11.2.2008 that some part of the assistance and supervision of the detailed engineering was provided by the applicant, it is not in conformity with the case of the applicant that Phase-II of BE & P agreement was not at all carried out. In

fact, Mr. R. Brook Smith, Manager of the applicant in his affidavit clarified that no work was carried out in respect of Phase-II of the two agreements, viz. BE & P - Project Management Services. It may be recalled that in the second phase of carrying out the detailed engineering services only, the applicant's personnel were required to supervise the work of local engineering contractor vide Art. IV of the Agreement. Now, coming to Phase-1 which consists of two types of services viz. basic engineering and procurement of long lead items, the averment of the applicant that procurement services were essentially performed from India is quite contrary to the terms of the Agreement. In Art. VII which refers to "price and price basis", the break-up of lump sum price in respect of Jamnagar to Bhopal and Goa to Hyderabad pipelines is given. In para A.1 and B.1 of Art. VII it is specifically stated : "lump sum fixed price for Phase 1 – basic engineering and procurement services of long lead items from Perth." Even in the written submissions dated 11.2.2008, the applicant clarified at page 2 that "the contractor was to provide basic engineering and procurement services from Perth, Australia and detailed engineering and procurement services from Mumbai." Further, para 3 of Appendix I which says that provision shall be made for seven Reliance project team members to be stationed at Contractor's head-office during phase I work reinforces the fact that phase I of the work was to be carried out from the head-office in Perth. It is not known on what basis the applicant has stated that services relating to procurement of long lead items were essentially performed in India. Assuming that something different from what had been stated in the agreement had factually taken place, the same should have been clarified. No material whatsoever has been placed before us to substantiate that the services relating to procurement which is an integral part of the BE & P Agreement were performed in India substantially or partly. Though the summary of invoices under which the amounts were received from time to time was given in a book filed at the last hearing, we do not find any details of the items of work covered by those invoices or the place of performing the related services. There is not a single document which goes to prove that procurement services relating to Phase-I were done in India. It is, therefore, not possible to conclude that PE at Mumbai had any role to pay in regard to the services covered by the first Agreement i.e. either basic engineering or procurement. There is another aspect which we would like to advert to in this context. Art. V of the Agreement sets out the "overall Schedule and Milestones." In regard to the Jamnagar to Bhopal Pipelines, it is stipulated: "Phase-1: Basic Engineering and ordering of long lead items shall be completed as per agreed sub-milestones before 20th October, 2001" (The schedule date of completion of Phase II work i.e. detail engineering etc. was 20th May, 2002). But, as seen from the Chart appended to the application, the first visit of two employees who stayed on for 75 days was only in October, 2001. In the succeeding month, 4 employees came and worked in India for a duration of 8 days. The Project Manager Mr. Mark Vaughan came to India only in April, 2002 and stayed for 236 days. Thus, by the date the applicant's employees started carrying out the work at the fixed place in Mumbai, their schedule for completion of first phase – both basic engineering and procurement was completed. This is also a pointer to the fact that PE did not have any role worth-mentioning in carrying out the services under Phase I of the first agreement. Basic Engineering & Procurement services constituting Phase I of the Agreement were evidently carried out from Perth without reference to any permanent establishment in India.

12.2. It is true that some preparatory work involving on-the-spot studies would have been done by the applicant's employees at the initial stages. For instance, item no.2 of phase-I mentions 'pipeline route studies'. So also for preparing the documents under item 3 as a prelude to statutory approval process such as environmental clearance etc., site inspections may be necessary. But, this process of on-the-spot observations and collection of data would have been done much before the PE became functional in India.

As already noted, the visits of applicant's personnel to India and their stay at Mumbai commenced only in October, 2001 by which date the services under the Ist Phase of Agreement were to be completed. It is not the case of the applicant that the PE came into existence even before Oct., 2001. On the other hand, the specific averment in the application shows that there were 'few trips to India for site visits and meetings' in connection with the basic engineering services. In the absence of any details, the few short visits of the employees deputed by the applicant for going ahead with the work under the Agreement cannot be construed to give rise to a permanent establishment at the initial stage itself. Presumably, faced with this difficulty, the learned counsel for the applicant repeatedly stressed that the two agreements entered into in connection with the project and executed partly have to be seen as one as they are integrally connected. In other words, the applicant would like to say that the effective connection to the PE stands established by reference to the services rendered under any one of the Agreements. It is also the case of the applicant that although the bulk of services under the first agreement (BE & P) were carried out in Australia, even those services have close connection with the PE for the reason that the work done in Australia was based on the inputs gathered in India for a project to be undertaken in India and the end-product of the technical/scientific services was delivered and utilized in India. None of these arguments, in our view, are legally tenable. In order to see whether the payments in the nature of royalties received by the applicant are taxable in India, the particular agreement under which the royalties were received should be considered on stand alone basis. A lump sum consideration with a break up of Phase I and II was stipulated under the agreement and the scope of work/services as well as the rights and obligations in the agreements are clearly separate and distinct, though related to one project. The inter-relation of the various agreements to the project as a whole cannot be denied. But that is not to say that the permanent establishment must be deemed to have effective connection with all the services – wherever and whenever rendered. It would be appropriate to apply the test of effective connection between the PE and the royalty related services with reference to each Agreement which is clearly separable from the other. Viewed from this angle, it cannot be said that the services giving rise to the royalties in connection with first agreement get effectively connected with the PE merely for the reason that some services under a different agreement were provided through the media of PE at a later stage. It would have been a different matter, if as averred in the application, the procurement services relating to phase-I were mostly or substantially performed in India. The reason is that procurement services are part of the very same agreement and even the consideration was not split up by reference to basic engineering services and procurement services. But, the applicant could not substantiate its statement that the procurement services were "essentially performed in India". Coming to the second aspect of the argument, the contention of the applicant is equally untenable. Performing and providing

services from Australia under the BE & P Agreement cannot, without anything more, give rise to effective connection with the PE in India. We reiterate that the effective connection contemplated by Art. XII(4) must be between the services giving rise to royalty and the PE. That there is overall connection of such services to the project and the fact that such services are essential for the execution of the project is a different aspect. Such overall connection unrelated to the role of the permanent establishment cannot be brought within the ambit of the exclusion clause contained in Art.XII(4). The words "effectively connected with the PE" are not words of redundance and should be given their due meaning, as discussed earlier. A real and perceptible connection should exist to fulfil the said criterion.

12.3. In order to decide the question whether effective connection exists between the services performed under the BE&P Agreement and the PE, basic facts relating to the functions exercised by the staff stationed at the PE, the work turned out by them in relation to the services under the agreement and the billing if any done by PE for the items of work done by it should have been placed on record. As the things stand, we have only bald and vague averments of the applicant.

Art. XII(4) (exclusion clause) considered from the standpoint of Ishikawajima decision

13. While on the point of applicability of the exclusion clause (Article XII.4 of the DTAA), it is necessary to refer to certain observations of the Supreme Court of India in Ishikawajima-Harima Heavy Industries vs DIT*. On a reading of the judgment as a whole, we find that the issues were considered from the point of view of Article 12.5 of the Indo-Japan DTAA, the scope of deemed income provision in S.9(1)(vii) and the territorial nexus principle. Their Lordships came to the conclusion that the offshore services in the nature of technical services having been rendered completely outside India with the PE having no role to play in respect thereof, the consideration received on account of such offshore services cannot be subjected to Indian income-tax either under Article XII of DTAA or under section 9(1)(vii) of the Act.

13.1. Now we will see what exactly has been said in the decision from the standpoint of Article 12.5 of Indo-Japan Treaty (corresponding to Article XII.4 of the Indo-Australian Treaty). At page 441 of ITR, it was observed thus: "Since the appellant carries on business in India through a permanent establishment, they clearly fall out of the applicability (sic) of Article 12(5) of the DTAA and into the ambit of Article 7." Then, it was observed that PE had no role to play in the transaction that was sought to be taxed. Thereafter, while laying down the propositions (vide page 447 of ITR), it was said that "the terms "effectively connected" and "attributable to" are to be construed differently even if the offshore services and the permanent establishment were connected." As far as this observation is concerned, what follows from the words of their Lordships is that the existence of effective connection with the PE does not automatically result in attribution of income to that PE because under Art.7.1, the profits that can be taxed are only those attributable to the PE, that is to say, the operations/activities of the PE. In fact,

para 6 of the Memorandum of Understanding (Protocol) reached between India and Japan specifically states that the term 'directly or indirectly' attributable to that PE shall be referable to profits arising from transactions in which the PE has been involved and such profits are attributable to the PE to the extent appropriate to the part played by the PE in those transactions. The Supreme Court has specifically referred to para 6 of the Protocol in construing the expression 'attributable'. The observation of their Lordships though contained in one sentence would imply that there may be situations in which the services etc. have an effective connection with the PE, still attribution in terms of Art. 7.1 may not be possible. Such an attribution could only be in accordance with what has been laid down in the Protocol to the DTAA. In this context, it is important to note that there is no categorical finding or observation of the Supreme Court anywhere in that case that the offshore services were effectively connected to the PE in India. On the other hand, the learned Judges guardedly added a rider while formulating propositions 2 and 6 to the following effect: "assuming the offshore elements form an integral part of the contract" and more importantly – "even if the offshore services and the permanent establishment were connected." We are of the humble opinion that the discussion proceeded on the basis that by reason of the exclusion clause contained in Article 12.5 of Indo-Japan Treaty, the clause dealing with business income i.e., Art.7 would apply and by applying the said Article, only that portion of the income arising from the operations of PE can be taxed in India. No specific finding was recorded by their Lordships on the point of 'effective connection', but the learned judges discussed the issue on the assumption that the exclusion clause applies and as a sequel to that Article 7 would come into play. Moreover, from what is stated at p.441, the Supreme Court cannot be said to have laid down a proposition that the mere existence of PE is enough to trigger the exclusion clause in Art.12.5 so as to make room to Art.7. Art.12.5 (corresponding to Art.XII.4 of India-Australia Treaty) categorically lays down the requirement of effective connection with the PE; otherwise, the exclusion provision would not come into play. In fairness to the applicant's counsel, we must say that the counsel did not choose to lay stress on the wording – "since the appellant carries on business through PE" occurring in the quoted sentence at p.441. He agreed that "effective connection" is an essential ingredient that has to be satisfied. In the case of services etc. falling under royalty or FTS, Art.VII gets attracted only if their effective connection with the PE is established.

13.2. There is one more aspect which will have some relevance in understanding the observations referred to supra. In the DTAA between India and Japan, the terminology of Art.12 is somewhat different. The phraseology used in Art.12.5 is "the right, property or contract in which the royalties or fees for technical services are paid is effectively connected with the PE". In such a case, Art.7 will apply. Instead of the word 'services' occurring in the Treaty with which we are concerned, the expression 'contract' is used therein. In view of this language of Art.12 (5), a view can be taken that the contract as a whole was effectively connected with the PE though the particular services (offshore services) were not so connected. Apparently, for this reason, their Lordships have proceeded on the premise that the offshore services forming part of the contract though rendered outside India were effectively connected to the PE, though the PE had no role in playing the actual rendering of such services.

13.3. Another proposition laid down by the Supreme Court in **Ishikawajima** case which needs to be explained is proposition No. 8. The legal position is stated thus:

"Article 7 of the DTAA is applicable in this case and it limits the tax on business profits to that arising from the operations of the permanent establishment. In this case, the entire services have been rendered outside India, and have nothing to do with the permanent establishment and can thus, not be attributable to the permanent establishment and therefore not taxable in India."

On the strength of the above passage it is possible to contend that in the instant case also, Article VII of the DTAA should be applied. As discussed earlier, Article VII comes into the picture only when the exclusion clause in XII.4 comes into play. To attract XII (4) there must be effective connection between the services giving rise to royalty income and the PE in India. In the case of **Ishikawajima**, it was not found as a matter of fact that the offshore services were effectively connected with the PE. On the other hand, the observation in the above extracted passage and elsewhere would show that the non-resident's PE in India had nothing to do with the offshore services. Then, why their Lordships have expressly stated that "article 7 is applicable in this case"? It seems to us that this proposition should be read along with the preceding two propositions No. 7 & 6. In proposition No.7 the application of section 9(1) (vii) (c) was ruled out by interpreting that provision in a particular manner. That means the income cannot be treated as FTS under the Act. It would then be business income having regard to the well established rule that if a matter is governed by the DTAA as well as statutory provision, whichever is more beneficial to the assessee, could be invoked, Art. 7 of DTAA could be invoked by the non-resident assessee as it turned out to be beneficial to him. Secondly, as discussed earlier, effective connection was assumed by their Lordships in paragraph 6 without expressing any opinion whether in fact such connection was there. At the cost of repetition, the words "even if the offshore services and the PE were connected" occurring in proposition No.6 are important. On such assumption, their Lordships proceeded to set out the legal consequence i.e. Article 7 being triggered by virtue of the operation of exclusion clause in Art.12 (5). In the present case, having regard to our categorical finding that the BE & P Services were not connected with the PE, Articles XII.2 and 3 govern the case of the applicant, there is no scope to invoke Art. VII through the route of Art. XII.4.

13.4. We, therefore, find nothing in the **Ishikawajima** Judgment that supports the applicant on the point of applicability of exclusion clause in Art. XII (4).

Ruling in P.No. 13/95 and Art. XII(4)

14. The counsel for the applicant relied on the ruling of this Authority in Advance Ruling P.No. 13/95, in re# 228 ITR 487 in support of his contention that the exclusion clause i.e. Art. XII (4) comes into play. In that case, a French company, 'ABC' proposed to enter into several agreements with the Indian company for providing complete project services" on single point responsibility basis starting from technology transfer to the commissioning of manufacturing plant" in India. For the purpose of providing the

services, ABC was to operate from its head office in France as well as project h.o. and site office in India. It expected to employ about 200 to 400 employees in India and 800 employees outside India. The work to be done by 'ABC' under all the agreements involved activities in India as well as outside India. Against the background of this proposed transaction, advance ruling was sought on 13 questions. Question Nos. 4, 7 and 8 are relevant for our purpose. Question no. 4 was: "whether the activities of ABC conducted outside India as enumerated in paragraph 6 of Annexure-I are effectively connected with the activities conducted inside in India by its PE in India". Question no. 7 sought ruling on the point whether the payments under the agreements were taxable under Art. 13.2 of the DTAA or whether in terms of Art. 13.6, the said amounts were liable to be taxed under Art. 7 of the DTAA. It may be mentioned that Art. 13.6 of the DTAA with France is similar to Art. XII.4 of Indo-Australian DTAA, it being an exclusion clause. Then, followed question no. 8 which raised the query whether the profits attributable to activities inside India alone will be liable to tax in India.

Answering the 4th question in the affirmative, the Authority observed, thus:

"All the outside activities are directed towards the installation of the manufacturing plant and industrial complex in India. Though carried out elsewhere, they are integrally connected with the project in India. The designs, basic engineering services and other services are based on information collected in India and the use of the process and technologies have to be adapted to the needs of, and prove workable in, Indian conditions. The permanent establishment in India has an undoubted voice over the outside activities as well and the royalties and fees in question cannot but be described as effectively connected with it."

14.1. In answer to question no. 7, it was held that the payments received by ABC were taxable under Art. 7 read with Art. 13.6. The 8th question was answered in the affirmative. Earlier, the inter-play of Art. 13 & 7 was explained, thus:

"This, no doubt, is the general rule. But this "concessional rate" if one can call it so, will not apply and the payments will cease to be assessable in terms of Article 13 and become assessable in terms of Article 7 if:-

(i) the beneficial owner of these kinds of payments carries on a business in India through a permanent establishment;

(ii) the payments in question arise in the course of such business; and
(iii) the payments are effectively connected with such permanent establishment.

These three conditions are satisfied in the present case."

14.2. The learned counsel for the applicant submits that on a parity of reasoning, the receipts in respect of services rendered outside India must be held to be effectively connected to the PE. However, we are not in a position to apply the ratio of that ruling to the present case. Keeping aside the question of impact of **Ishikawajima** verdict on the

observations extracted supra (at para.14), more importantly, we find distinguishing features on facts. The PE in India with a large number of employees (more than 200) working with it had an "undoubted voice over the outside activities as well", whereas it is not the case here. The PE of ABC was expected to play a crucial role in respect of all services – whether performed outside or within India. Moreover, in that case, by the date of application or disposal thereof, the activities did not start. Apparently, no PE was functional at that time. The ruling was sought in respect of proposed activities under the contract. Hence, there was no occasion to give ruling on the basis of actual state of affairs. Excepting the version of the applicant and relevant clauses in the proposed Agreement, the Authority could not examine the actual role and functions of PE which did not come into existence till then. Nor could the applicant place any material thereon. The position here is different. As observed earlier, no material has been placed before us as to the exact role played by PE and whether it had anything to do with the BE&P services, though these facts were well within the knowledge of applicant. On the other hand, there are enough indications, as stated earlier, that the PE would have been set up at a later stage by which time the BE&P services would have been almost completed.

Other points regarding Art. XII (4)

15. As regards Art. XII (4), another issue debated was whether in the event of holding that the services constituting 'royalty' are effectively connected to the PE in India, the entire receipts shall be taxed only in accordance with Art. VII to the complete exclusion of Article XII (2). The contention of the Revenue is that the receipts resulting from the services effectively connected to the PE shall be taxed in the manner provided by Article VII and the remaining receipts arising from the services unconnected to the PE would still be taxable under Article XII(2) of DTAA read with section 9(1)(vi) of the I.T. Act. Referring to the phraseology of Article XII (4), it is contended that the exclusion provision in Article XII (4) shall be strictly confined to that part of the income arising from the services connected with the PE. Otherwise, it is pointed out by the Revenue's representative that an anomalous situation could arise. A non-resident performing the entirety of services from abroad in respect of a project to be carried out in India, will have to pay tax on the entire of 'royalty' income by reason of the fact that it has not set up a PE in India whereas a non-resident rendering few services through the media of a small PE set up in India will be able to avoid the payment of tax on "royalty" income except in respect of those few services rendered through the PE.

15.1. In this context, the learned counsel for the applicant has relied on the observation in **Ishikawajima** case at page 441 of ITR, i.e. "Since the appellant carries on business in India through a permanent establishment, they clearly fall out of the applicability of article 12 of the DTAA and into the ambit of article 7." However, from this observation we do not find answer to the contentious issue that has been set out earlier. The question of inter-play between Article 12 and Article 7 in the sense in which it is projected before us did not arise for consideration of the Supreme Court. No support can be drawn from the above observation which merely spells out broadly the effect of Article 12(5). There is, however, no need to express any opinion on this aspect, having regard to the view taken by us in regard to the PE.

16. The Departmental representative submits that the very argument of the applicant that the services carried out and offered from Perth were effectively connected with the PE cuts at the root of the applicant's case because the logical consequence of such argument is that the receipts from all such services will have to be attributed to the PE under Art. 7. The entirety of the profits so attributable to the PE will then be assessed as business income though not as 'royalty' income. The departmental representative submits that it is difficult to envisage a situation where it can be said that the services are effectively connected to the PE, but at the same time cannot be attributed to the PE. We need not deal with this argument in view of our finding that the services required to be performed under the BE & P Agreement were not connected with the PE in India.

Ishikawajima decision vis-à-vis Sec.9 (1) and territorial nexus principle

17. Then, we come to the next aspect which was addressed by their Lordships in **Ishikawajima** case while discussing the issue of taxability of the income related to offshore services. The deemed income provision contained in Section 9(1)(vii) and territorial nexus in relation thereto was discussed and the interpretation of Section 9(1)(vii) was so adopted as to encapsulate the territorial nexus principle. It is pointed out by the learned counsel for the applicant that although the Supreme Court was interpreting Section 9(1) (vii) which relates to fees for technical services, the same interpretation and the same approach should be adopted in interpreting Section 9(1) (vi) dealing with royalty income as the opening part of both the clauses is couched in the same language.

17.1. Before we proceed to examine this contention, we must analyse and understand the judgment in **Ishikawajima** and its ratio decidendi. In substance and in ultimate analysis what has been laid down in that decision in regard to the taxability of offshore services rendered by non-resident is this: Sufficient territorial nexus between the rendition of services and territorial limits of India is necessary to make the income taxable (vide proposition no. 1, at page 447). The entire offshore services having been done by the applicant from its head office outside India and the PE in India was not involved in them, the consideration for such technical services cannot be subjected to tax in India by taking resort to Section 9. Income cannot be deemed to accrue or arise in India under section 9, if there is no territorial nexus. The services rendered abroad (for which separate consideration was stipulated), though utilized in India by the Indian enterprise, do not establish sufficient territorial nexus. Sub-clause (c) of section 9(1) (vii) [FTS provision] has to be so interpreted as to import the requirement of rendering services in India. In other words, both rendering and utilization of services in India is essential under the said provision. Otherwise, the requirement of territorial nexus will not be satisfied. Even under the DTAA, the income relating to offshore services cannot be taxed in India inasmuch as the entire services were rendered outside India, the PE of the applicant had nothing to do with them and, therefore, the receipts relating to them cannot be attributed to the PE. Territorial nexus and the principle of apportionment of income between two fiscal jurisdictions are inter-related and can be given effect to even in relation to the contract involving execution of turn-key project if the supplies/ services in connection therewith are spread over in the country of source as well as residence. Thus, the amount

payable under the contract for offshore services entirely done abroad cannot be taxed in India, but, it must be allocated to the other country where they were carried out.

17.2. The relevant provisions of Income-tax Act need to be referred to in order to appreciate the implications of that decision in a proper perspective. Section 4 is the pivotal charging section of the Income-Tax Act, 1961. It must be read along with Section 5(1) & (2) which define the scope of total income of a resident [vide sub-section (1)] and the total income of a non-resident [vide sub-section (2)] respectively. Sub-section (2) of Section 5 which is material for our purpose lays down:

"(2) Subject to the provisions of this Act, the total income of any previous year of a person who is a non-resident includes all income from whatever source derived which –

(a) is received or is deemed to be received in India in such year by or on behalf of such person; or

(b) accrues or arises or is deemed to accrue or arise to him in India during such year.

Explanation 1: Income accruing or arising outside India shall not be deemed to be received in India within the meaning of this section by reason only of the fact that it is taken into account in a balance sheet prepared in India.

Then, Section 9 explains as to what income shall be deemed to accrue or arise in India within the meaning of clause (b) of section 5(2).

17.2A.. In the latest decision in **CIT, New Delhi vs. M/s. Eli Lilly and Company (India) Pvt. Ltd#**. the Supreme Court discussed the nature and scope of section 9. S.H. Kapadia, J observed thus:

"a general charge of income-tax is imposed by Section 4 and 5, and that general charge is given a particular application in respect of non-residents by Section 9 which enlarges the ambit of taxation by deeming income to arise in India in certain circumstances."

Earlier it was observed: "Section 9 which deems certain categories/heads of income to accrue in India has no application in cases where income actually accrues in India. Likewise, Section 9 does not apply in cases where income is received in India. Therefore, if the income is not received in India, a non-resident would not be chargeable to tax upon it unless it accrues or is deemed to accrue in India".

Section 9 was described to be a combination of machinery provision as well as charging provision.

17.3. On an analysis of Section 9(1), we find that under the first clause, all income accruing or arising, whether directly or indirectly through or from any business connection in India or property in India or any asset or source of income in India or through the transfer of a capital asset situate in India shall be deemed to accrue or arise in

India. The Explanation thereto engrafts a limitation on the rule laid down in clause (i). Explanation (a) lays down that in the case of a business of which all the operations are not carried out in India, the deemed income under the clause shall be confined only to such part of the income as is reasonably attributable to the operations carried out in India. Then follow the specific clauses deeming certain specific heads of income as accruing or arising in India in certain circumstances and subject to certain limitations. Those specific items are salaries, dividend, interest, royalty and fees for technical services. We have already extracted clause (vi) of Section 9(1) which relates to income by way of royalty and which is relevant for our purpose. Sub-clause (vii) of Section 9(1) dealt with by the Supreme Court in **Ishikawajima** relates to fees for technical services. It reads thus:

(vii) income by way of fees for technical services payable by –

(a) the Government; or

(b) a person who is a resident, except where the fees are payable in respect of services utilized in a business or profession carried on by such person outside India or for the purposes of making or earning any income from any source outside India; or

(c) a person who is a non-resident, where the fees are payable in respect of services utilised in a business or profession carried on by such person in India or for the purposes of making or earning any income from any source in India.

It may be noticed that these three sub-clauses of clause (vii) are identical to the three sub-clauses of clause (vi).

17.4. In the case of **Ishikawajima** as well as the present case, it is sub-clause (b) that applies because the payment was made by a resident to a non-resident for the services undertaken by the latter in respect of a contract executed in India. The fact that the appellant company was a non-resident who provided services to a person resident in India is clearly stated at page 444 and also at page 430 of I.T.R. However, instead of sub-clause (b), sub-clause(c) was referred to and interpreted. The structure and language of sub-clause (b) is quite different from sub-clause (c). After referring to Section 9(1) (vii) (c), the Supreme Court observed at pg.444:

"Reading the provision in its plain sense, it can be seen that it requires two conditions to be met – the services which are the source of the income that is sought to be taxed, has to be rendered in India, as well as utilized in India, to be taxable in India. In the present case, both these conditions have not been satisfied simultaneously, therefore excluding this income from the ambit of taxation in India. Thus, for a non-resident to be taxed on income for services, such a service needs to be rendered within India, and has to be part of a business or profession carried on by such person in India. The petitioners in the present case have provided services to persons resident in India, and though the same have been used here, they have not been rendered in India."

17.5. On a reading of the above passage, two things are not clear: First, why reference has been made to sub-clause (c) of Section 9(1) (vii) instead of sub-clause (b) which is couched in a different language and deals with a different situation? The relevant portion in sub-clause (b) that covered the case of the appellant - **Ishikawajima** is the "income by way of fees for technical services payable by a person who is a resident." In sub-clause (b), there is no mention at all of the services being utilized, much less rendered, in India. Secondly, why their Lordships stated that sub-clause (c) of Section 9(1)(vii) specifically* requires two conditions to be met, namely, that "the services which are the source of income that is to be taxed has to be rendered as well as utilized in India" in order to be taxable in India? The expression 'rendered', perhaps used in the sense of 'performed' is not to be found even in the inapplicable clause (c). Though it is difficult to find an answer, we cannot ignore the dicta in the above passage. We have to respect the observations of the Supreme Court and the spirit behind it, without invoking the doctrine of per incuriam as far as possible. The overall impression we get, especially after reading some of the subsequent paragraphs, is that their Lordships wanted to interpret Section 9(1) (vii) in harmony with territorial nexus principle. Hence, the requirement of rendering the services in India was read into the said provision, though specifically that requirement is not to be found in that clause. A reference to certain other passages would perhaps throw better light in understanding the implications of the dicta laid down in **Ishikawajima** case. At page 443, it was observed: "Section 9 spells out the extent to which the income of non-resident would be liable to tax in India. Section 9 has (sic) a direct territorial nexus". The following passages at pages 444-445 which have bearing on the interpretation of the opening part of Section 9(1)(vii) [which is in pari materia with Section 9(1)(vi)] are also relevant.

"92. Section 9(1)(vii) of the Act whereupon reliance has been placed by the learned Additional Solicitor General, must be read with section 5 thereof, which takes within its purview the territorial nexus on the basis whereof tax is required to be levied, namely, (a) resident; and (b) receipt or accrual of income."

"94. What is relevant is receipt or accrual of income, as would be evident from a plain reading of section 5(2) of the Act. The legal fiction created although in a given case may be held to be of wide import, but it is trite that the terms of a contract are required to be construed having regard to the international covenants and conventions. In case of this nature, interpretation with reference to the nexus to tax territories will also assume significance. Territorial nexus for the purpose of determining the tax liability is an internationally accepted principle. An endeavour should, thus, be made to construe the taxability of a non-resident in respect of income derived by it. Having regard to the internationally accepted principle and DTAA, it may not be possible to give an extended meaning to the words "income deemed to accrue or arise in India" as expressed in section 9 of the Act. Section 9 incorporates various heads of income on which tax is sought to be levied by the Republic of India. Whatever is payable by a resident to a non-resident by way of fees for technical services, thus, would not always come within the purview of section 9(1) (vii) of the Act. It must have sufficient territorial nexus with India so as to furnish a basis for imposition of tax." (emphasis supplied)

17.6. Again, at page 447, under the heading 'offshore services', the first proposition laid down was "sufficient territorial nexus between the rendition of services and territorial limits of India is necessary to make the income taxable". The Supreme Court ultimately commented that this Authority (AAR) had committed an error in treating the services rendered abroad by the head office of the appellant – **Ishikawajima** as services rendered by the permanent establishment in India. In other words, the linking up of the offshore services to the permanent establishment in India which was not involved in carrying out those services was considered to be a wrong approach.

Observations in Ishikawajima on legal fiction and source of income

17.7 The Supreme Court observed at page 430 that "having regard to the contextual interpretation", the legal fiction created by S.9 should be construed having regard to the object which it seeks to achieve. However, it is not indicated as to what is the object of the said provision that deters the legal fiction being carried to the extent specifically provided by the language of the Section. The object of section 9(1) is to deem certain incomes as income accruing or arising in India so as to widen the net of taxation in respect of the resident's and non-resident's income by dispelling doubts and controversies as to the situs of accrual of income. In fact, in the various treaties entered into with different countries, the power of taxation of the State wherein royalties arise is recognized. Thus, the object of Section 9 will in no way be defeated if the legal fiction enacted by Section 9, is taken to its logical extent.

17.8 It is also relevant in this context to take note of the observation of a three judge bench of the Supreme Court in **Ashok Leyland vs. State of Tamil Nadu**^ while dealing with a deeming provision in a tax statute. It was observed after referring to certain decisions on the point, "these decisions show that whenever a legal fiction is created by a Statute, the same shall be given full effect" (vide p.34). In a case arising under the CST Act, viz., **Consolidated Coffee Ltd. vs. Coffee Board***, the following pertinent observations were made by the Supreme Court while explaining a deeming provision:

"The word 'deemed' is used a great deal in modern legislation in different senses and it is not that a deeming provision is every time made for the purpose of creating a fiction. A deeming provision might be made to include what is obvious or what is uncertain or to impose for the purpose of a statute an artificial construction of a word or phrase that would not otherwise prevail, but in each case it would be a question as to with what object the legislature has made such a deeming provision".

17.9 On the point of territorial nexus there is one more observation of the Supreme Court which needs to be explained. Under the same heading "offshore services" - proposition no.10 (at page 447) says: "the location of the source of income within India would not render sufficient nexus to tax the income from that source."

In our humble view, the said observation cannot be construed to mean that the age-old test of source of income should be eschewed altogether while considering territorial nexus. At best, the quoted statement may mean that the source test is not always

decisive. That the Supreme Court found the source test as a relevant factor in the earlier part of discussion deserves mention in this context. It was categorically observed at page 434: "even there is nothing to prevent the income accruing or arising at the sources". Not only that, the dicta of Kania C.J. in **CIT vs. Ahmed Bhai*** was approvingly referred to in the same page (434). The learned Chief Justice emphatically stated: "I am however unable to accept the contention that the source of income can never be the place where the income accrues or arises".

Certain grey areas left out by Ishikawajima and the approach to be adopted in appreciating the ratio of a Judgment

18. A doubt still lingers in one's mind as to why the Supreme Court proceeded on the basis that the offshore services performed by the contractor executing a turn key project as a step-in-aid to the execution of the project and deploying those services in India had no real connection to the Indian territory? Do they not give rise to a 'live link'* with the Indian territory? Why their Lordship felt that the income arising therefrom did not accrue or arise in India, not to speak of deemed accrual? One would not find a direct answer on a perusal of the judgment of the Supreme Court because the nuances of territorial nexus principle were not the subject-matter of discussion. At the same time, we are by duty bound to give effect to the law - be it the ratio decidendi of the judgment or the obiter dicta of the Supreme Court. But, we must bear in mind the apt and instructive words of the Supreme Court spelling out the approach to be adopted and the caution to be observed in appreciating the law declared by a decision of the Supreme Court. In the case of **CIT vs. Sun Engineering Works** Ltd.^ , the principle was succinctly stated thus: "The judgment must be read as a whole and the observations from the judgment have to be considered in the light of the questions which were before this court. A decision of this court takes its colour from the questions involved in the case in which it was rendered and, while applying the decision to a later case, the courts must carefully try to ascertain the true principle laid down by the decision of this court and not to pick out words and sentences from the judgment, divorced from the context of the questions under consideration by this court, to support their reasonings".

That is how the ratio of a judgment has to be ascertained and applied.

In **Arnit Das vs. State of Bihar***, the Supreme Court referred to the passage in **State of UP vs. Synthetics & Chemicals Ltd**.** wherein it was pointed out that "a decision not expressed and accompanied by reasons and not proceeded on a conscious consideration of issue cannot be deemed to be a law having binding effect as is contemplated under Art.141 of the Constitution. That which has escaped in the judgment is not the ratio decidendi".

Territorial nexus – other decisions

19. Before we proceed to apply the ratio of **Ishikawajima** decision to the facts of the present case, we may advert to the principles laid down in some important cases on the aspect of territorial nexus.

19.1. In **Hoechst Pharmaceuticals Ltd. vs. State of Bihar****, a three judge bench of the Supreme Court observed "sufficiency of territorial nexus involves a consideration of two elements viz. (a) the connection must be real and not illusory and (b) the liability sought to be imposed must be pertinent to that territorial connection: (State of Bombay vs. Chamarbaugwala)……..".

19.2. In the case of **A.H. Wadia vs. CIT, Bombay**##, the Federal Court examined the validity of Section 42(1) of the Indian Income tax Act, 1922 on the anvil of territorial connection. It was held that the provision in Section 42(1) which brought within the scope of the charging section the interest earned out of money lent outside but brought into British India was not ultra vires the powers of the Indian legislature on the ground that it was extra-territorial. Section 42(1) brought four heads of income within the ambit of the charging section. They were: Income accruing or arising directly or indirectly (a) through or from a business connection in British India (b) through or from any property in India (c) through or from any asset or source of income in British India and (d) when arising from any money lent as interest and brought into British India in cash or in kind. Kania C.J. referred to the following dicta of Spens C.J. in the case of Raleigh Investment Co@ "if some connection exists the legislature is not compelled to measure the taxation by the degree of benefit received in particular cases by the tax payer. This affects the policy and not the validity of the legislation". Then, the following crucial observation was made:

"All the four heads of income mentioned in Section 42(1) show a real connection between the person receiving income under the particular head and India. Once such connection is held to exist it is unnecessary to ascertain the extent of the connection."

Again, at page 73 it was observed:

"The short question to be decided is whether income arising out of a transaction with these incidents establishes some real territorial connection between the person and British India or not. In my opinion the answer is in the affirmative because the source, i.e., the source from which the income accrues to the lender is known to be going into British India in cash or in kind and this incident is an integral part of the money-lending transaction. As mentioned above, the extent of the connection, if it is real, is not relevant to be discussed in considering the validity of the legislation."

Thus, the Federal Court has clearly laid down the principle that the extent and amplitude of territorial connection is not really material.

19.3. In a very recent decision,* the Supreme Court aptly noted that in Wadia's case "the Federal Court held that so long as the Statute (Income-tax Act, 1922) selected some fact or circumstance which provided some connection or nexus between the person who is subject to the tax and the country imposing the tax, its validity would not be open to challenge on the ground that it is extra-territorial in operation".

Under section 9(1)(ii) which fell for consideration in the said decision, salary income 'earned in India' shall be deemed to accrue or arise in India. The Explanation to clause (ii) declared that income related to the service rendered in India shall be regarded as income earned in India. Interpreting section 9(1)(ii) in the light of the test laid down in Wadia's case, their Lordships observed that "if the payments of Home Salary abroad by the foreign company to the expatriate has any connection or nexus with his rendition of service in India then such payment would constitute income which is deemed to accrue or arise to the recipient in India as salary earned in India in terms of Section 9(1)(ii)".

19.4. In the case of **Electronics Corporation of India vs. CIT***, a Norwegian company entered into an agreement with ECIL, Hyderabad to provide technical know-how and services including facility for training of personnel for which it was paid in Norwegian currency. Norwegian company did not have any office or any business activity in India. It appears that the services were all rendered in Norway. The question was whether the appellant was liable to deduct tax at source in respect of fees for technical services falling under Section 9(1)(vii). The High Court repelled the contention that Section 9(1)(vii) was beyond the legislative competence of Parliament as it had the potential of extra-territorial operation. On appeal to the Supreme Court, a three judge bench heard the matter and referred the case for determination by a Constitution bench. Before the larger Bench took up the matter for consideration, it seems to have been withdrawn. However, certain observations made while referring the matter to the Constitution bench are quite pertinent. Their Lordships, at the outset, pointed out that a Parliamentary Statute having extra-territorial operation cannot be ruled out from contemplation. Reference was made to Art.245 (2) which declares that the law made by Parliament shall not be deemed to be invalid on the ground that it would have extra-territorial operation. The argument founded on the extra-territorial operation of the law was rejected in the following words:

"while the enforcement of the law cannot be contemplated in a foreign State, it can, none the less, be enforced by the courts of the enacting State to the degree that is permissible with the machinery available to them. They will not be regarded by such courts as invalid on the ground of such extra-territoriality."

19.4. However, the principle of territorial nexus was treated separately and the following observations were made to pave the way for the pronouncement by a Constitution bench:

"But the question is whether a nexus with something in India is necessary. It seems to us that, unless such nexus exists, Parliament will have no competence to make the law. It will be noted that article 245(1) empowers Parliament to enact laws for the whole or any part of the territory of India. The provocation for the law must be found within India itself. Such a law may have extra-territorial operation in order to subserve the object and that object must be related to something In India. It is inconceivable that a law should be made by Parliament in India which has no relationship with anything in India. The only question then is whether the ingredients, in terms of the impugned provision, indicate a nexus. The question is one of substantial importance, especially as it concerns collaboration agreements with foreign companies and other such arrangements for the

better development of industry and commerce in India. In view of the great public importance of the question, we think it desirable to refer these cases to a Constitution Bench.

Application of the ratio/dicta of the decision in Ishikawajima to the facts of present case

20. As stated earlier, this Authority has to give full effect to the law laid down and the observations made by the Supreme Court vis-à-vis territorial nexus in the context of Section 9(1) (vii) (similar to Section 9(1)(vi)). There is no doubt that the facts of the present case should be tested in the light of the ratio underlying the decision of Supreme Court in **Ishikawajima**. Even then, we are unable to hold that the territorial nexus is lacking in the present case just as in the case of **Ishikawajima**. This is not a case where the entirety of offshore services were performed in a foreign country which was the base of the contractor. Even on the showing of the applicant, about 20% of the services were performed in India. A perusal of Appendix A to the Agreement would reveal that the nature of certain items of work specified therein was such that they could be carried out in India only. For instance, in the list given under the caption 'Scope of work and Services', items such as (1) & (2) require spot inspection, study of topography etc. Under the head "Basic Engineering Deliverables" (Annexure I), plot plans and layouts, topographical route maps, geotechnical data along pipeline route are mentioned. The inputs in this regard can only be gathered by doing certain activities on the Indian soil.

Moreover, the applicant had to undertake the activities in India such as spot inspection, study and analysis and holding periodical meetings in connection with procurement services. All these activities which are prerequisites or components of the services rendered afford sufficient territorial nexus to tax the receipts in India, though the major part or most of the services relating to phase I of BE & P Agreement were carried out in Perth. It is not the extent and magnitude of services rendered in Perth and in India that is decisive. We have already adverted to the exposition of law by the Federal Court in this regard. The territorial nexus vis-à-vis the power of taxation has never been understood in a narrow sense. Approaching the issue from this perspective, we are of the view that the territorial nexus is real and identifiable in the instant case. The 'live link' referred to in proposition no. 5 is present in the case on hand. The activities expected to be undertaken in India in connection with Phase I of BE&P Agreement are not insufficient or negligible in nature. In **Ishikawajima**, there is a specific finding that all the offshore services were rendered outside India i.e. from the headquarters of the appellant Company. It has been stated so in the extracts given at P. 425 of ITR. But, in the instant case, even keeping aside the fact that the benefit of services was made available to Reliance in connection with its project in India, the fact remains that some of the activities/services contemplated by the BE&P Agreement itself were carried out from India, though such activities were done without reference to any permanent establishment. Therefore, there is no legal taboo against the application of S.9 (1) (vi) of I.T.Act by deeming the royalty income as having accrued or arisen in India. The deeming fiction can be given its due effect without offending the principle of territorial nexus.

Project Management Services

21. Then, we turn our attention to the Project Management Services (PMS) covered by the Second Agreement. We have already referred to the main provisions therein. The case of the applicant that by the date of closure of the contract, certain project management services were performed in India through the PE has to be accepted. The nature of the services coupled with the calculation of amount payable to the applicant based on estimated man days 'at Mumbai' would lead to the conclusion that these services would not have been performed from Perth only. The presence of the applicant's personnel for considerable number of days appears to be necessary to discharge the responsibilities cast on the applicant under this Agreement. The P.M. services had apparently commenced after the basic engineering phase was over and the basic designs, drawings and procurement plans were made ready. It was at that stage i.e. in the month of October, 2001 that the PE was set up in Mumbai and the applicant's management and technical personnel stayed in Mumbai for days together and worked from the office of the local engineering contractor, namely, Jacobs Engineering Co. The estimated completion date for the project management related services was 30th November, 2002, as seen from Art.V of the Agreement. Keeping all these factors in view, we have no hesitation in holding that the P.M. services were effectively connected with the PE located in Mumbai and the receipts therefrom (which according to the applicant is 899,189 Aust. Dollars) shall be treated as business income and be taxable only to the extent they are attributable to the operations of PE in India.

Rate of Tax

22. It is the contention of the applicant that only so much of the receipts that are attributable to the PE in India are taxable at the rate of 20 per cent (plus surcharge, if any). The applicant further submits that in view of section 44D, no deductions are permissible and, therefore, the portion of receipts attributable to the PE will be taxable on gross basis. In this regard, the stand of the applicant is: "though due to operation of Art.12.4, receipts are to be taxed under Art.7, yet the receipts will be characterized as royalties". However, we have come to the conclusion that Art. VII read with Art. XII. 4 is not attracted and the entire royalty income accruing or arising to the applicant under the Ist Agreement is liable to be taxed in India under the Income-tax Act, 1961 read with Art. XII (2) of DTAA. We have ruled out the attribution of profits to the PE under the BE & P Agreement. In regard to the computation and the rate of tax, the provisions of the Income-tax Act and the DTAA governing the royalty income, whichever is more beneficial to the assessee shall be applied. As far as the computation of income is concerned, both according to the provisions of the Income-tax Act, 1961 viz. Section 44D and Art. XII (2) (b) of DTAA the tax is payable on the gross amount without deductions.

The rate of tax of 15 per cent specified in Art. XII (2) (b) being lower than the rate prescribed by Section 115A of the Act, the same shall be applied. Hence, the royalty income has to be subjected to tax at the rate of 15 per cent on the gross amount.

22.1. However, the payments received under the Project Management Services Agreement are liable to be taxed to the extent attributable to PE as business profit and are to be taxed on net basis at the appropriate rate applicable to business income.

Conclusions

23. In view of the foregoing discussion, the answers to the questions formulated by the applicant (vide para 3 supra) are as follows:

Q.nos. (a) & (b): The services rendered and the work undertaken by the applicant in terms of the Agreement for Basic Engineering and Procurement services fall within the scope of "royalties" as defined in Art. XII (3) of the DTAA between India and Australia and the receipts are taxable in India by virtue of Art. XII (2). Under the Act too, they are so taxable.

Though the applicant had a PE in India set up in October, 2001 or thereafter, there is no proof to the effect that the services contemplated by the said Agreement were in anyway connected with the PE. The effective connection between the PE and the royalty generating services under the BE & P Agreement is not established.

Q.nos. (c) & (d): The exclusion clause under Art. XII (4) of the DTAA is not attracted in view of the absence of effective connection between PE and the services, and therefore, the royalty income is liable to be taxed under Art. XII (2) of the DTAA read with section 9(1) (vi) and other charging provisions of the Act. The question of attribution of only a part of the income to the PE does not arise as Art. VII which envisages such principle does not apply.

The entire receipts under the BE & P Agreement are liable to be taxed as royalty income on gross basis and at the rate of 15 per cent However, the receipts from the P.M. Services agreement, shall be treated as business income and be taxable only to the extent they are attributable to the operations of PE in India. The permissible deductions and rate of tax concerning business income will be applicable.

The Ruling is accordingly given and pronounced on this the 30th day of March 2009.

sd/-	sd/-	sd/-
(A. Sinha)	(P.V. Reddi)	(Rao Ranvijay Singh)
Member	Chairman	Member

F.No. AAR/747/2007/ Dated 31/03/2009

This copy is certified to be a true copy of the advance ruling and is sent to:

1. The applicant.
2. The Director of Income-tax(International Taxation-II) New Delhi..
3. The Joint Secretary (FT&TR-I), M/Finance, CBDT, North Block, New Delhi.
4. The Joint Secretary (FT&TR-II), M/Finance, CBDT, North Block, New Delhi
5. Guard file.