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IN THE INCOME TAX APPELLATE TRIBUNAL
MUMBAI L BENCH, MUMBAI

Before Shri Pramod Kumar (Accountant Member)
and Shri R S Padvekar (Judicial Member)

ITA No. 4896/Mum/03
Assessment year 1995-96

Linklaters LLP ***……………….Appellant***

Vs.

Income Tax Officer- International Taxation ***………… Respondent***
Ward 1(1)(2), Mumbai

ITA No. 5085/Mum/03
Assessment year 1995-96

Income Tax Officer- International Taxation
Ward 1(1)(2), Mumbai ***……………….Appellant***

Vs.

Linklaters LLP ***………… Respondent***

Assessee by : Shri S E Dastur,
Shri P J Pardiwala, and
Shri Neeraj Sheth
Revenue by : Shri Narendra Singh

O R D E R

Per Pramod Kumar:

1. These cross appeals call into question correctness of learned Commissioner (Appeals) order dated 13th March, 2003, in the matter of assessment under section 143(3) r.w.s. 250 of the Income Tax Act, 1961,

for the assessment year 1995-96. Both of these two appeals, pertaining to the same assessee and involving interconnected issues arising out of common set of facts, are being disposed of by way of this consolidated order.

2. The assessee before us is a United Kingdom based partnership firm engaged in the practice of law. In addition to its principal office in London, the assessee has offices in major business centers outside India, such as Brussels, Frankfurt, Hong Kong, New York, Paris, Singapore, Tokyo, Moscow, and Sao Paulo. There is, however, no dispute that the assessee does not have any branch office or any other similar form of presence in India. During the relevant previous year, the assessee firm rendered services to certain clients whose operations extended to India, and these services were in connection with projects in India. The services so rendered were rendered from outside India as also from within India. The services were rendered from outside India by assessee's London office, but at times partners and staff members of the assessee firm also visited India to render these professional services. The assessee had worked for following projects for which partly work was done in India and partly work was done outside India:

Sl.No.	*Name of the Client*	*Name of the Project / Matter*
1.	*Denro Ispat*	*Chandrapur coal project*
2.	*CESC*	*Balagrah power project*
3.	*Enron Power*	*Indian power project*
4.	*Hinduja National Power*	*Vizag*
5.	*Dresdner Kleinwortbenson*	*Bajaj GDR issue*

6.	*Barclays Capital*	*Finolex Cables GDR*
7.	*S.S. Warburg Securities Ltd.*	*India cements Limited*
8.	*HSBC Investment Bank PLC*	*Sriram Enterprises GDR*
9.	*Lazard Brothers & Co. Ltd.*	*Usha Beltron GDR issue*
10.	*Chase Manhattan Asia Ltd.*	*INOC issue*
11.	*Barclays Capital*	*Hindustan Dev Corp.*
12.	*BICC PLC*	*Optical Fiber Cable JV*
13.	*Merril Lynch*	*Ganesh*
14.	*Holsten Braucreiag*	*Malaria Pills*
15.	*BNP Paribus*	*EID Parry GDR 1*
16.	*City Corp International*	*Ballarpur Industries*
17.	*Mernil Lynch & Co.*	*Gujarat State Fertilizer*
18.	*Oppenhermer & Co. Inc.*	*Western Paeques GDR*
19.	*Jardine Fleming*	*Western Pacques GDR*
20.	*Chase Securities Inc.*	*Essar Gujarat*
21.	*Credit Lyonnais*	*Ruchie Soya*

3. The assessee filed its return of income in India on 31st October 1995 disclosing *nil* taxable income in India. As elaborated in the course of assessment proceedings, it was case of the assessee that since the assessee did not have any fixed place of business in India, it could not be held that the assessee had a permanent establishment or fixed base in India, and, for that short reason, its income from the services rendered in India could not be brought to tax in India either under Article 7, dealing with 'business profits', or under Article 15, dealing with 'independent personal services', of the India UK Double Taxation Avoidance Agreement

(206 ITR Statute 235; 'India UK tax treaty', in short). It was also contended that the list contained in Article 5(2), which was by no means exhaustive, was of examples each of which can be regarded prima facie as constituting a PE but such examples are to be seen against the background of general definition given in Article 5(1) in such a way that examples listed in Article 5(2) are PE only if they meet the requirements of Article 5(1) of tax treaty. It was thus argued that in order that the assessee can be said to have a PE in India, the basic conditions of Article 5(1) are to be necessarily satisfied, and merely satisfying the requirements of any of the sub clauses in Article 5(2), even if that be so, would not suffice. It was also contended that there was no continuity of activities in India, and the partners and staff members of the assessee firm visited India only on as and when required basis. The activities of the assessee were claimed to be sporadic or isolated. The stand of the assessee thus was that there was no framework or infrastructure, no continuity and no stability so as to result in a permanent establishment. The assessee contended that, in any event, the activities of assessee do not involve furnishing of services as envisaged in Article 5(2)(k) of the Indo UK tax treaty as the assessee is an international professional enterprises rendering services directly to its clients. It was also contended by the assessee that the professional services rendered by the assessee can at best be covered by Article 15 but, in any event, Article 15 extended to only individuals and not to the partnership firms or other forms of business organizations. It was submitted that the assessee cannot be taxed under Article 7 as the assessee did not have a PE in India under the provisions of Article 5(2)(k) read with Article 5(1), and the assessee can not be taxed under Article 15 as the said Article only applies to the services rendered by individuals whereas the assessee is a partnership firm. It was contended that since the provisions of the applicable tax treaty were beneficial to the assessee, these treaty

provisions will override the provisions of the Indian Income Tax Act, 1961, and the income of the assessee cannot be brought to tax under the provisions of the Indian Income Tax Act either

4. None of these submissions, however, impressed the Assessing Officer. The Assessing Officer was of the view that in case one is to proceed on the basis that a permanent establishment under Article 5(2)(k) can come into existence only when provisions of Article 5(1) are to be satisfied, "the provisions contained in Article 5(2)(k) would be rendered redundant since, in that case, person would come to India for extended period of time without opening a branch or any establishment in India and claim that there does not exist a PE". He also relied upon the ruling given by the Authority for Advance Ruling in P. No. 28 of 1999 (reported as XYZ In Re 242 ITR 208) in support of the proposition that such an interpretation, as canvassed by the assessee, will run contrary to well established principle of statutory interpretation that an inclusive definition is intended to add to the primary meaning, so as to bring within its scope items which may or may not fall within the sope of primary definition. The Assessing Officer also rejected the contention of the assessee that the assessee renders services which is distinct from 'furnishing of services' as contemplated under Article 5(2)(k), as, according to the Assessing Officer, the expression 'rendering' and 'furnishing' are synonymous in this context. A reference was then made to the provisions of Section 9(1)(i) of the Income tax Act, and it was pointed out that when as assessee has a business connection in India, it is that business connection which brings the related income to the ambit of taxability in India. It was also observed that the tax treaty does not define the expression 'business profits' and, therefore, the connotations of business profits depend on the domestic law provisions and the surrounding factors. The Assessing Officer was of the view that the

income from professional services rendered is also taxable as business profits, and, in any event, the nature of work done by the assessee, which extended to structuring of various projects, attending to meetings with project sponsors, negotiating the floating rate issues and advising on any information required on projects in India, was such that the assessee "has entered into the arena of business activities in true commercial sense". It was thus held that the income from services rendered by the assessee is taxable as business profits under Article 7. Without prejudice to this line of reasoning, the Assessing Officer also held that the income earned by the assessee is also taxable under Article 15 as 'independent personal services' and he relied upon the decision of this Tribunal in the case of Clifford Chance Vs DCIT (82 ITD 106) in support of the same.

5. Having held that the income of the assessee from projects in India is taxable in India, the Assessing Officer turned to quantification of the income so liable to be taxed in India. It was noted that without prejudice to assessee's contentions regarding non taxability of its income in India, the assessee had enclosed an income and expenditure account in which income has been computed as follows:

	In UK £
Income	**6,91,190**
Less :	
Direct expenditure	**1,88,206**
Overheads (5% of income)	**34,565**
Profits	**4,68,419**

6. It was also noted that the above computation was based on the position stated at Note 10 of the statement accompanying the income tax return and the position stated in the tax audit report attached to the return of income. A perusal of these documents revealed that the

assessee had prepared a profit and loss account with reference to the fees charged to the clients as could reasonably be attributed to the work performed in India. According to the assessee, the basis of apportionment of fees in accordance with the India UK tax treaty requires "estimation of fees with reference to the fees rates at which such services could have been procured from corresponding professionals acting in India". The costs incurred by the assessee, which were attributable to the PE, were allocated to the PE in the following manner – (a) direct costs were allocated on the basis of number of hours spent at the pro rated UK salary cost; and –(b) overheads have been allocated @5% of income. When the assessee was asked to justify the computation of income so offered to tax, the assessee once again relied upon the provisions of Article 7(2) which requires the computation of profits which the PE would have earned if it was wholly independent of the general enterprise and such a computation of profits, according to the assessee, requires consideration for services rendered by the PE to be taken at a fair and reasonable price having regard to the market conditions. It was submitted that the income of the PE is computed on the basis of actual man hours devoted in India to a particular client and charged at the rates would have been charged by the Indian lawyers for similar services.

7. However, the Assessing Officer was not convinced by the interpretation of Article 7(2) canvassed by the assessee. He referred to observations made in the OECD Commentary to the effect that "it should perhaps be emphasized that the directive in paragraph 2 is no justification for the tax administration to construct the hypothetical profit figures in vacuum; it is always necessary to start with the real facts of the situation as they appear from the business records of the permanent establishment". He observed that the rates charged by the assessee are admittedly more than these hypothetical rates adopted for

computation of PE profits, and there is no justification for disregarding the actual incomes attributable to PE and adopting hypothetical amounts. It was thus concluded that the actual revenues in respect of the PE in India are to be taken into account for the purpose of computing income of the PE. A reference was then made to the ruling given by the Hon'ble Authority for Advance Ruling in the case of Steffen, Robertson & Kirsten Consulting Engineers & Scientists, In Re (230 ITR 206) wherein it is observed that, " A careful reading of Section 9, together with the Explanations thereto, makes it clear that the statutory test for determining the place of accrual of income is not the place where these services are rendered but where those services are utilized". Therefore, irrespective of the place where services are rendered, income should be deemed to accrue or arise in India. The Assessing Officer, having noted that the assessee has taken into account charges only for services rendered in India, thus held that whether the services rendered from India, or from outside India, the entire income in connection with projects in India is required to be taxed in India. He thus took into account the overall amounts invoiced by the assessee in respect of services rendered for Indian projects. It was also noted by the Assessing Officer that amounts invoiced to the clients were in the nature of invoices for professional fees as well as invoices/ requisitions for reimbursements of expenditure. While Assessing Officer noted assessee's claim that the reimbursements of expenses are in respect of actual expenditure incurred by the assessee, on behalf of clients, and have no element of mark up or income, he treated 50% of such reimbursements of expenditure as income on the ground that "the assessee has not been able to produce all such bills/ invoices and considering the facts these bills do not, in any case, have any supporting evidences". An amount of Rs 2,12,23,219 was thus brought to tax. The Assessing Officer further observed that since the assessee has not deducted tax at source in

respect of salaries for the work carried out in India, salary in relation to work done in India could not be allowed as deduction. As regards the salary for work done outside India, the Assessing Officer rejected the claim on account of , what he termed as, "absence of any details furnished by the assessee". The Assessing Officer thus computed income of the assessee at Rs 22,52,84,384 on the basis of following computation:

	In UK£		In Indian Rupee
Amounts invoiced	2,94,570.36		
Amounts invoiced	44,00,805.24		
	46,95,375.60		
1 UKP = Rs.50.34		=	Rs.23,63,65,207.70
Add:	In US$		
Amounts invoiced	6,91,552.01		
1 US$ = Rs.31.37		=	Rs. 2,16,93,986.55
Add:	In HKD		
Amount invoiced	75,488		
1 HKD = Rs.4.06		=	Rs. 3,06,481.28
TOTAL AMT INVOICED			Rs.25,83,65,675.53
Less: Disbursements at above rates			
UK£ – 8,02,486.13 =	Rs.4,03,97,151		
US$ – 68,327 =	Rs. 20,49,307		
HKD – 488	Rs. 1,981		
	Rs. 4,24,48,439		
Disbursements allowed at 50% as discussed			Rs. 2,12,24,219
			Rs. 23,71,41,456
Less: 50% overhead of above			Rs. 1,18,57,072
			Rs. 22,52,84,384
Add:			
Receipts not taken into account for computing income under Indian matter as under:			
Nippon Denro	Rs.1,08,21,119		
Serum Institute of India	Rs. 5,80,757		Rs. 1,14,01,876
TOTAL TAXABLE INCOME			**Rs. 23,66,86,260**
			==============

8. Aggrieved by the stand so taken by the Assessing Officer, assessee carried the matter in appeal before the CIT(A) but without complete success. While the CIT(A) upheld the action of the Assessing Officer so far as existence of permanent establishment in India is concerned, he held that under Article 7(1) of the India UK tax treaty as also under Explanation (a) to Section 9(1)(i), only income in respect of such work can be brought to tax in India as has been carried out in India. The CIT(A) rejected the adjustments done by the assessee in respect of revenues for work done by the PE and adoption of hypothetical market rates for such services in India, and held that only actual billing amount is to be taken into account. While holding so, the CIT(A), inter alia, made following significant observations:

<u>On the question of existence of PE</u>

"……….. The contention of the learned A.R. cannot be accepted for the following reasons.

- *Para 2 of Article 5 of the DTAA provides the circumstances under which permanent establishment arises in a Contracting State. Para 2 provides for specific instances over and above the general provisions contained in para 1 of Article 4 e.g. duration of construction contract, furnishing of services other than technical services, etc. It is a well accepted principle that specific provisions prevail over the general provisions. Therefore, if the conditions provided in para 2 of Article 5 are satisfied, it will amount to a permanent establishment irrespective of the fact whether the general provisions of Article 5(1) cover such a situation or not.*

- *The term furnishing of services as referred in Article 5(2)(k) also includes rendering of services. In commercial parlance, there is no difference between furnishing of services and rendering of services. The services excluded from the purview of Article 5(2)(k) are technical services as referred to in Article 13. The services provided by the appellant are not in the nature of technical services as*

defined in Article 13 and therefore the provisions of Article 5(2)(k) squarely apply to the appellant's case.

- *There is no dispute on the fact that the presence of appellant's personal and partners in India was for more than 90 days in the relevant previous year.*

Therefore, in view of the above, I hold that the appellant had a permanent establishment in India under Article 5(2)(k) of the DTAA and this ground of appeal is rejected."

On adjustment required under Article 7(2) by adopting fair market value of the services rendered by the PE – for quantification of income of PE -

…….the appellant has argued that in computing the income of the permanent establishment in India, the rate per hour for a partner should be considered at Pounds Sterling 100 per hour and for an assistant at Pounds Sterling 70 per hour, being the rates which an Indian lawyer would have charged in the circumstances.

…………I agree with the findings of the assessing officer. It is only real income which should be charged to tax, and not the notional income as computed by the appellant. Article 7(2) of the DTAA only provides that for the purpose of computation of profit of permanent establishment, it has to be treated as separate and distinct entity of the enterprise of which it is a permanent establishment. It does not provide that profit of the permanent establishment is to be determined on the basis of what other enterprises in the other contracting State would have earned. Therefore, I confirm the findings of the assessing officer that the profit of the appellant's permanent establishment in India has to be computed on the basis of the actual rates charged by the appellant and not at the notional rates.

On taxability of services rendered outside India in connection with projects in India

…….On a careful consideration, I find force in the learned A.R's arguments. I have perused the detailed analysis chart provided by

the appellant to the assessing officer regarding the amount of invoice relating to services rendered in India and the amount relating to services rendered outside India. I have also perused the invoices raised by the appellant. From the details, it can be observed that more than 90% of the invoices are raised by the appellant on foreign enterprises. Further, in many cases, the appellant has rendered services in relation to ADR/GDR or Bound issues outside India. Therefore, it will be incorrect to assume that the services rendered by the appellant are utilized in India. In any event, I agree with the learned A.R. that the income earned by the appellant were not in the nature of fees for technical services as defined in section 9(1)(vii) and therefore the AAR Ruling in the case of S.R.K. Consulting Engineers (supra) will not apply to the facts of the appellant.

6.10 Even in the case of Clifford Chance (82 ITD 106) the Hon'ble Mumbai Bench of ITAT has held that the income relating to services rendered outside India is not taxable in India. At para 64 of the order, the Hon'ble ITAT has observed as under:-

> *6.4 The question in the present case is very simple. If assessee proves that it rendered services outside India, its income to that extent can be excluded while computing its total income for determining tax payable in India. But this was not done. In the absence of any document and proof issue cannot be decided in favour of the assessee……."*

In the present case, the appellant has provided exhaustive details regarding hours spent in India and outside India. The appellant has also provided bifurcation of income relating to services rendered in India and outside India. Services rendered in India and services rendered outside India were charged at the same rates on time basis, depending on the individual who spent the time. Even in the assessment order, the assessing officer has herself determined the income related to services rendered in India and related to services rendered outside India. There is no dispute about the quantum of income related to services rendered in India and outside India. Therefore, as held by the Hon'ble Mumbai Tribunal, income related to services rendered outside India has to be excluded in computing the total income of the appellant.

> *6.11 I also agree with the learned A.R's arguments that as per Article 7, only that portion of income, which is attributable to the permanent establishment in India, can be taxed in India. The appellant has a permanent establishment in India as per Article 5(2)(k) only for the reason that the appellant has rendered the services in India for more than 90 days. Therefore, only that portion of income relating to rendering of such services in India can be attributed to the services PE of the appellant in India."*

9. As regards the reimbursement of expenses, the CIT(A) upheld the action of the Assessing Officer to the extent of 15% of the total amount of reimbursement. As regards levy of interest under section 234 B on the delay in payment of advance tax amount, the CIT(A) deleted the same on the ground that entire amount received by the assessee was subject to deduction of tax at source under section 195 and, therefore, the assessee cannot be faulted for not paying the advance tax.

10. None of the parties is satisfied by the decision of the CIT(A), and both the parties are in cross appeals before us on the following grounds :

<u>Assessee's grounds of appeal</u>

1. The Learned Commissioner (Appeals) ought to have directed the Assessing Officer to determine the total income of the appellant at Rs. Nil as returned by the appellant.

2. The Learned Commissioner (Appeals) erred in holding that the appellant had a permanent establishment in India under Article 5(2)(k) of the Tax Treaty between India and the U.K. The Learned Commissioner (Appeals) ought to have appreciated that appellant had no permanent establishment in India.

3. Without prejudice to the above, the Learned Commissioner (Appeals) erred in not directing the Assessing Officer to accept the computation provided by the appellant in the Income and Expenditure Account as being the income attributable to the permanent establishment. The Learned Commissioner (Appeals) ought to have directed the Assessing Officer to adopt the gross income at 6,91,190

pounds deduction for direct expenditure at 1,88,206 pounds, deduction for overheads 34,565 pounds and net profit 4,68,419 pounds.

4. Without prejudice to the above, the Learned Commissioner (Appeals) erred in not directing the Assessing Officer to compute the total income at the number of hours charged at appropriate rates for an Indian lawyer viz 100 pounds per hour for a partner and 75 pounds per hour for an assistant.

5. The Learned Commissioner (Appeals) erred in upholding the action of the Assessing Officer in considering reimbursement of expenditure of 8,02,486.13 pounds, 65,327 US dollars and HKD 488 as part of income of the appellant and as liable to tax in India.

6. The Learned Commissioner (Appeals) erred in confirming the disallowance of disbursements to the extent of 15% of the disbursement claim proportionate to the fee relating to services rendered in India as compared to the total fees. The Learned Commissioner (Appeals) ought to have directed the Assessing Officer to allow deduction for the entire amount of the disbursements.

7. The Learned Commissioner (Appeals) erred in not quashing the penalty proceedings u/s 271(1)(c) of the Act initiated by the learned Assessing Officer."

Assessing Officer's grounds of appeal

1. On the facts and in the circumstances of the case and in law, the learned CIT(A) has erred in holding that, interest u/s 234B of the Act was not chargeable in the case of assessee, on the ground that in the case of a non-resident assessee, all sums chargeable to tax are liable to deduction of tax at source u/s 195 of the Act.

2. On the facts and in the circumstances of the case and in law, the learned CIT(A) has erred in holding the assessee was taxable in respect of only that portion of income that was related to services performed in India. The learned CIT(A) has not appreciated the "force of attraction" principle in Article 7 of the Indo-UK DTAA."

11. We have heard the rival submissions, perused the material on record and duly considered factual matrix of the case as also the applicable legal position.

Taxability under the domestic law

12. One of the arguments which is raised by the learned counsel for the assessee, in support of the conclusions arrived at by the CIT(A) to the effect that income from only such services can be brought to tax in India as are rendered through the Indian permanent establishment, is that even under the domestic law, only income relatable to the services rendered in India can be taxed in India. Learned counsel did not dispute that so far as income from the work carried out by the assessee in India is concerned, the same is taxable in India under the domestic law, though he hastened to add that this aspect of the matter is wholly academic since under the applicable tax treaty, the income from even work done by the assessee in India cannot be brought to tax in India.

13. On the question of taxability under the domestic law, learned counsel's basic contention is that even under the domestic law, the income of the assessee firm is taxable only to the extent the work has been carried out in India. It is submitted that in view of Hon'ble Bombay High Court's judgment in the case of Clifford Chance vs DCIT (318 ITR 237) only such services as are rendered in India can be subjected to tax in India. Therefore, according to the learned counsel, even under domestic law, we cannot bring to tax services rendered to Indian projects from outside India. When learned senior counsel's attention was drawn to the amendments in Section 9 as proposed by the Finance Bill 2010, and impact of these amendments, when carried out, on Clifford Chance judgment of Hon'ble Bombay High Court, it was submitted that these amendments, even if carried out, will at best require reconsideration of Clifford Chance decision by Hon'ble Bombay High Court, whenever these issues come up before Their Lordships again, but, under no

circumstances, it can be said that Clifford Chance will not be good law even after the amendments are brought in force. It was submitted that these amendments pertain to the taxability of fees for technical services, and, as such, do not directly cover the issue in appeal before us. Beyond these submissions, learned counsel did not make any further comments on the amendments proposed by the Finance Bill 2010. Learned Departmental Representative submits that now that amendments to Section 9 are under the legislative process, and learned counsel has been heard on the same, we should proceed to pass the order only after the legislative process for amendments is completed. He further submits that the theory of territorial nexus, which constituted foundation of Hon'ble Bombay Court's judgment in the case of Clifford Chance, has been negated by the proposed amendments to Section 9, and once the proposed amendments are carried out, the said decision cannot be said to be good law. When legal provisions are no longer *pari materia*, the judicial precedent based on the pre amendment position cannot be said to be legally binding. It is contended that the judgments of Hon'ble Bombay High Court in the case of Clifford Chance is anyway clearly contrary to the legislative intent behind the scheme of Section 9, and that the doubts, if any, about the legislative intent , have now been set at rest by the retrospective amendment in Explanation to Section 9(1)(vii), as introduced by the Union Budget. It is submitted that once the proposed amendments are carried out, these judicial precedents will no longer constitute good law. It is submitted that as long as the source of income is in India, and irrespective of whether work is carried in India or outside India, the income is deemed to have arisen in India. Learned Departmental Representative thus urged us to hold that entire fees for services rendered by the assessee in India as also abroad are taxable in India as long as services are utilized in India. It may be added that the proposed amendments relied upon by the learned Departmental

Representative, on which we have also heard the learned counsel for the assessee, are since carried out and legislative process for the same is duly completed.

14. We agree with the learned counsel that the facts in the case of Clifford Chance were materially similar to the facts of the case before us. In the case of Clifford Chance also, the assessee was an English law firm and was rendering legal services in connection with certain projects in India, namely, Bhadravati Power Project, Vizag Power Project and Raviva Oil and Gas Field Project. While the claim of the assessee was that only such portion of the fees received, in connection with these projects is taxable in India as is attributable to services performed in India, the Assessing Officer opined that the total fees received for the India Project, whether the work was done in India or outside India, was taxable in India. When this dispute finally travelled before the Hon'ble Bombay High Court, it was, inter alia, contended by the assessee that **"the place of utilization of service is not relevant but place of performance of the service is what would be determinative (of taxability)……."** and reliance was placed on Hon'ble Supreme Court's judgment in the case of Ishikawajima Harima Heavy Industries Ltd. vs. DIT (288 ITR 408). Their Lordships noted that the taxability is to be determined under section 9(1)(vii) of the Act, and observed as follows:

> **"The apex court had occasion to consider the above question in the case of Ishikawajima Harima [2007] 288 ITR 408 (SC), wherein, while interpreting the provisions of section 9(1)(vii)(c) of the Act, the Supreme Court held as under (page 444) :**
>
> > **"Section 9(1)(vii)(c) of the Act states that 'a person who is a non-resident, where the fees are payable in respect of services utilized 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 of India'."**

Reading the provision in its plain sense, as per the apex court 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. Both the above conditions have to be satisfied simultaneously. 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.

In the above judgment, the apex court observed that (page 444):

> **"section 9(1)(vii) of the Act 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 of accrual of income". According to the apex court, the global income of a resident although is subjected to tax, the global income of a non-resident may not be. The answer to the question would depend upon the nature of the contract and the provisions of the DTA. What is relevant is receipt or accrual of income, as would be evident from a plain reading of section 5(2) of the Act subject to the compliance with 90 days rule.**

As per the above judgment of the apex court, the interpretation with reference to the nexus to tax territories also assumes 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 the DTAA, no extended meaning can be given 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 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 ax. Whereas a resident would come within the purview of section 9(1)(vii) of the Act, a non-resident would not, as services of a non-resident to a resident utilized in India may not have much relevant in determining whether the income of the non-resident accrues or arises in India. It must have a direct link between the services rendered in India. When such a link is established, the same may again be subjected to any relief under the DTAA. A distinction may also be made between rendition of services and utilization thereof.

With the above understanding of law laid down by the apex court, if one turns to the facts of the case in hand and examines them on the touchstone, section 9(1)(vii)(c) which clearly states…where the fees are payable in respect of services utilized 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 is thus, evident that section 9(1)(vii)(c), read in its plain, envisages the fulfillment of two conditions : services, which are source of income sought to be taxed in India must be (i) utilized in India, and (ii) rendered in India. In the present case, both these conditions have not been satisfied simultaneously.

15. It is thus unambiguous that the judgment of Hon'ble Bombay High Court rests on the legal premises that, under section 9(1)(vii), "services, which are source of income sought to be taxed in India, must be (i) utilized in India; and (ii) rendered in India" and the conceptual premises that "territorial nexus for the purpose of determining the tax liability is an internationally accepted principle". These legal premises, however, do no longer hold good in view of retrospective amendment w.e.f. 1st June 1976 in section 9 brought out by the Finance Act, 2010.

Under the amended Explanation to Section 9(1), as it exists on the statute now, it is specifically stated that the income of the non-resident shall be deemed to accrue or arise in India under clause (v) or clause (vi) or clause (vii) of section 9(1), and shall be included in his total income, whether or not (a) the non-resident has a residence or place of business or business connection in India; or (b) the non-resident has rendered services in India. It is thus no longer necessary that, in order to attract taxability in India, the services must also be rendered in India. As the law stands now, utilization of these services in India is enough to attract its taxability in India. To that effect, recent amendment in the statute has virtually negated the judicial precedents supporting the proposition that rendition of services in India is a *sine qua non* for its taxability in India. The paradigm shift in the legal provisions, or perhaps a mere conceptual clarity – as could perhaps be a possible point of view, is too glaring to be missed. In this view of the matter, it cannot really be said that the change in law brought about by amendment in Explanation to Section 9(1)(i) does not affect the aforesaid decision.

16. The entire rationale of the judgment is on the basis of Their Lordships' analysis of legal provisions of Section 9(1). After analysing Hon'ble Supreme Court's judgment in the case of Ishikawajima Harima Heavy Industries Ltd. vs. DIT (supra), in paragraph 47 of the judgement, Their Lordships have observed that **"In is thus evident that section 9(1)(vii)(c), read in its plain sense, envisages the fulfilment of two conditions : services, which are source of earning income sought to be taxed in India must be (i) utilized in India, and (ii) rendered in India"** and that "**In the present case, both these conditions have not been satisfied simultaneously**". It is on this basis that Their Lordships came to the conclusion that **"In the above view of the matter, contentions raised by the assessee/ appellant are to be accepted**".

The conclusions arrived at by Their Lordships were thus entirely based on their reading of the scope of Section 9(1) of the Income Tax Act, but in view of the retrospective amendment in Explanation to Section 9(1), the scope of this provision does no longer permit the interpretation adopted by Their Lordships. The very conceptual foundation of Hon'ble Bombay High Court's decision in the case of Clifford Chance (supra) ceases to hold good in law. When the legal provisions considered in the judicial precedent, vis-à-vis the legal provisions prevalent when that precedent is sought to be applied, are not in *pari materia*, the judicial precedent cannot have precedence value.

17. A school of thought does exist to the effect that the concept of territorial nexus, for the purpose of determining the tax liability, is relevant only for a territorial tax system in which taxability in a tax jurisdiction is confined to the income earned within its borders. Under this system, any foreign income that is earned outside of its borders is not taxed by the tax jurisdiction, but then apart from tax heavens, the only prominent countries that are considered territorial tax systems are France, Belgium, Hong Kong and the Netherlands, and in those countries also this system comes with certain anti abuse riders. In other major tax systems, the source and residence rules are concurrently followed. On a conceptual note, source rule of taxation requires an income sourced from a tax jurisdiction to be taxed in this jurisdiction, and residence rule of taxation requires income, earned from wherever, to be taxed in the tax jurisdiction in which earner is resident. Section 9 of the Income Tax Act embodies the source rule. As observed by Hon'ble Justice S Ranganathan, as Chairman of the Hon'ble Authority for Advance Ruling, in the case of Steffen, Robertson & Kirsten Consulting Engineers & Scientists, *In Re* (230 ITR 206), "A careful reading of Section 9, together with the Explanations thereto, makes it clear that the statutory test for

determining the place of accrual of income is not the place where these services are rendered but where those services are utilized". The source rule thus requires the taxability of an income in the tax jurisdiction in which the services are utilized, whereas residence rule requires taxability in the tax jurisdiction in which service provider has fiscal domicile. It is this conflict of source and residence rules which has been the fundamental justification of mechanism to relieve a taxpayer, whether under a bilateral treaty or under domestic legislations, of the double taxation - either by way of exclusion of income from the scope of taxability in one of the competing jurisdictions or by way of tax credits. Except in a situation in which a territorial method of taxation is followed, which is usually also a lowest common factor in taxation policies of tax heavens, source rule is an integral part of the taxation system and any double jeopardy, due to inherent clash of source and residence rule, to a taxpayer is relieved only through the specified relief mechanism under the treaties and the domestic law. It is fallacious to proceed on the basis that territorial nexus to a tax jurisdiction being sine qua non to taxability in that jurisdiction is a normal international practice in all tax systems. This school of thought is now specifically supported by the retrospective amendment to section 9.

18. It is, therefore, free from any doubt that Hon'ble Bombay High Court's judgment in the case of Clifford Chance is no longer good law, as there have been amendments in law in consonance with the school of thought discussed above and these amendment unambiguously negate the principle of territorial nexus which is the understructure of line of reasoning adopted by the Hon'ble Courts above. It is no longer necessary that, in order to invite taxability under section 9(1)(vii) of the Act, the services must be rendered in the Indian tax jurisdiction

19. In view of the above discussions, we are of the considered view that the entire fees for professional services earned by the assessee, in connection with the projects in India and which is thus sourced from India, is taxable in India under the domestic law. We reject the contentions advanced by the learned counsel.

20. Having held so, however, we may add that under the scheme of the Indian Income Tax Act, where the Government of India has entered into an agreement, with the Government of any country outside India for granting of relief, or as the case may be, for avoidance of double taxation, then, in relation to the assessee on whom such agreement applies, the provisions of this Act shall apply only to the extent they are more beneficial to that assessee. The provisions of tax treaties thus override the provisions of the Income Tax Act, except to the extent provisions of the Income Tax Act are beneficial to the assessee. The taxability under domestic law is thus to be examined in conjunction with the provisions of the applicable tax treaty. The next question that we need to examine, therefore, is whether the status of taxability of this income under the provisions of the India UK tax treaty.

<u>Assessee's entitlement to the benefits of India UK tax treaty</u>

21. During the course of hearing, it was noticed that the assessee firm was a fiscally transparent entity and was not liable to tax in UK in its own right. It was in this backdrop that we did put it to learned counsel whether the assessee, being a fiscally transparent entity which is not a taxable entity under the laws of the treaty partner country i.e. United Kingdom, can be treated as a 'resident of the United Kingdom' within meanings of that term under the India UK tax treaty, and whether, in this view of the matter, the assessee is entitled to the benefits of the tax

treaty at all. It was pointed out that unless an assessee is 'resident of one of the contracting states', as defined in the tax treaty, the assessee cannot claim the treaty protection under section 90(2). His attention was also invited to the controversy surrounding the admissibility of tax treaty benefits to fiscally transparent entities, and also to the decision on this issue from South Africa in the case of JJ Grudlingh Vs Commissioner for South African Revenue Service (Case No. A 33/2008 - IBFD database; also reported as Appellant Vs CSARS 10 ITLR 446). He was asked to address us on the admissibility of treaty protection, before proceeding to address on the specific substantive provisions of the India UK tax treaty.

22. Learned counsel submits that since the Assessing Officer as also the Commissioner (Appeals) have not questioned this aspect, it is not open to us to raise that issue at this stage of the proceedings. It has been nobody's case that the assessee is not entitled to the treaty benefits at all. We are, according to the learned counsel, expanding the scope of appeal before us – something beyond the scope of our powers. Our attention was invited to Hon'ble Bombay High Court's judgment in the case of Pokhraj Hirachand Vs CIT (49 ITR 293). It is submitted that all that we are to decide at this stage is the issues raised by the appellants, and we cannot travel beyond that to unsettle the settled matters. Without prejudice to these objections on jurisdiction, learned counsel for the assessee also addressed us on merits on assessee's eligibility for treaty benefits.

23. Learned counsel submits that the assessable unit is the partnership firm itself, though the manner of computation of tax liability is such that the tax payable by the partners is taken into account. Our attention is drawn to the UK Inland Revenue's assessment order of the assessee shows assessment order drawn up in the name of the firm, though the tax is computed with reference to the tax liability of the

partners. The expression 'liable to tax', according to the learned counsel, must include the person who is under an obligation to file the income tax return, in whose hands the income is determined and from whom taxes are recovered. The assessee fulfils all these tests, on the facts of the present case. Learned counsel also submits that the expression 'liable to tax' must be given a liberal meaning and as appropriate to the context in which this question is relevant. It is submitted that treaties are to be interpreted in good faith and to make them workable.

24. Our attention was also drawn to Article 3(2) of the India UK tax treaty, which states that a partnership which is treated as a taxable unit under the Indian Income-tax Act, shall be treated as a person for the purposes of this Convention. It was pointed out that in view of this specific provision in the India UK tax treaty and that considering that even a foreign partnership firm is a taxable unit in India, in case we are to hold that the partnership firm is not entitled to the treaty benefits, it will result in a patent absurdity. It is also submitted that the specific provisions under Article 3(2) unambiguously show that the India UK tax treaty was meant to be applicable to the entities which were taxed as partnership firms in India, as no other purpose can be served by this reference.

25. Learned counsel also submits that as evident from a reading of Hon'ble Bombay High Court's decision in the case of Clifford Chance (supra), Hon'ble Bombay High Court has proceeded on the basis that treaty benefits are available to Clifford Chance, which was also a UK based partnership firm. Our attention is drawn to specific observations of the Hon'ble High Court, which refer to Article 15 of the India UK tax treaty and make a reference to "clause 15 of the DTAA read with section 9 of the Income Tax Act". Learned counsel contends that once Hon'ble

Bombay High Court holds, directly or indirectly, that a partnership firm is entitled to treaty benefits, it cannot be open to us to take any other view of the matter.

26. As regards the decision in the case of JJ Grudingh (supra), learned counsel submits that this was a case in which partnership firm was treated as a fiscally transparent entity in both the treaty partner countries, and, as such, it will have no application on the facts of the present case, i.e. in a situation in which partnership firm is treated as opaque entity in the source jurisdiction and as transparent entity in the residence jurisdiction. It is also submitted that the text of the judgment does not provide full information about applicable legal provisions in the relevant tax jurisdictions, and, as such, this decision cannot have any bearing on the question as to whether or not a partnership firm in UK is entitled to the treaty benefits under India UK tax treaty.

27. Learned counsel further submitted that when words of a tax treaty are less than unambiguous, even if that be so, the Courts and Tribunals have to interpret these words so as to advance the objectives and purposes of the tax treaty rather than so as to frustrate the undisputed objectives and purposes of the tax treaty. According to the learned counsel, this peculiar problem regarding eligibility of tax treaty benefits arises, if at all it can be deemed to arise, because of asymmetrical tax treatment to partnership firm in the treaty partner tax jurisdictions, and, the treaty should be so interpreted as to resolve this unintended incongruity. We are thus urged to so interpret the tax treaty as to ensure meaningful interpretation to the provisions of tax treaty.

28. Learned Departmental Representative submits that the point of dispute before us is taxability of income from a definite source, and the

authorities below have given their reasons of taxability, or non taxability, of the said income. The subject matter of appeal is to be considered in the light of income taxability of which is impugned in appeal before the Tribunal, and not the legal issues raised before the Tribunal. The reasoning given by the Tribunal to uphold the stand of the authorities below may be different vis-à-vis the reasoning adopted by the authorities below, but as long as subject matter of taxability is the same income, it is open to the Tribunal to approve that taxability on reasons other than the reasons adopted by the lower authorities. It is submitted that the Tribunal has an inherent duty to decide the matter in accordance with the law, and it cannot decline to do so merely on the ground that the authorities below have not raised those fundamental legal issues, which govern taxability of income or otherwise affect the issue in appeal. He relies upon the judgment of Hon'ble Supreme Court in the case of CIT Vs Assam Shipping & Travels (198 ITR 1) in support of the proposition that it is duty of the Tribunal to decide the matter in accordance with the law, and that its powers to do so are not fettered by the actions of the authorities below. It is, according to the learned Commissioner, open to us to examine the matter in accordance with the law and on any of grounds whether or not that ground is raised by the parties, as long as the affected parties have been heard on the same. It is pointed out that, under the scheme of the Income tax Act, the Tribunal can pass such orders on an appeal as it thinks fit as long as parties have been heard on the grounds on which the matter is decided by the Tribunal. The grounds of appeal before the Tribunal do thus not fetter the powers of the Tribunal. Learned Departmental Representative further submits that the eligibility or ineligibility of the tax treaty benefits was of no consequence to the Assessing Officer since the entire income, whether in respect of work carried out in India or outside India in respect of Indian projects, was held to be taxable under the provisions of tax treaty as well. As this

issue was academic, the Assessing Officer did not really address the same. This issue is, however, relevant now as the CIT(A) has given partial relief on the basis of treaty provisions. We are thus urged to decide the issue of eligibility of treaty benefits on merits, and reject the technical objection raised by the assessee.

29. Learned Departmental Representative invites our attention to the definition of 'resident of a contracting state', as set out in Article 4(1), which states that resident of a Contracting State means "any person who, under the law of that State, is liable to taxation therein by reason of his domicile, residence, place of management or any other criterion of a similar nature". It is pointed out that as evident from Article 1(1) of the India UK tax treaty, the treaty can only apply to a person who is resident of one or both the contracting states. Therefore, in view of the provisions of Article 4(1) read with Article (1) and on the facts of this case, unless the assessee can be said to resident of UK, the assessee cannotr claim treaty benefits, and unless the assessee is liable to tax in UK, assessee cannot fulfill the requirement of being a resident in UK. He further submits that it is not in dispute that in the United Kingdom, a partnership firm is not taxable unit so far as income of the partnership firm is concerned, and the expression 'liable to tax' cannot include a person who is not a taxable unit. Only such a person whose income is taxed can be covered by the definition of the expression 'liable to tax'. The expression 'liable to tax', according to the learned Departmental Representative, covers only such entities which have tax liability in respect of their own income. He further submits that the determination of firm's income, in the course of assessment proceedings in United Kingdom, is only for the purposes of ascertaining correct income of the partners. It is emphasized that what is taxable is income of the partners, and even if assessment is framed in the name of the partnership firm, that is a part of mechanism

for ascertainment of income and realization of taxes. The tax liability of the partnership firm, even if so, is not its own right, but at best as a vicarious liability for its partners. It is submitted that since a partnership firm is not 'liable to tax' in the United Kingdom, the partnership firm cannot be granted treaty benefits in India. We are thus urged to hold that the assessee is not eligible for the benefits of India UK tax treaty.

30. Learned Departmental Representative further submits that when provisions of the tax treaty are clear and unambiguous, there is no occasion for venturing into finding out intentions of the treaty makers and discovering hidden meanings of the terms of the treaty. The principles of interpretation of tax treaties, according to the learned Departmental Representative, are not relevant when words in the treaty are clear and unambiguous, as in the case before us. He also submits that hardship to the assessee or consequences of an interpretation cannot influence the implication of the treaty provisions.

31. We are not inclined to uphold the technical objection raised by the learned counsel. Undoubtedly, in a situation when assessee is in appeal, Tribunal cannot give a finding adverse to the appellant so as to place him in a position worse than what it was before the appeal. However, in the case before us, both the parties are in appeal, and we are not venturing into an area where a finding, if adverse to the assessee, will make him worse off vis-à-vis the position in the assessment, because whether the assessee is entitled to the treaty benefits or not, his taxable income does not go beyond what was assessed by the Assessing Officer. As learned Departmental Representative rightly contends, the issue was entirely academic at that stage since, even under the provisions of the treaty, entire income of the assessee relatable to project in India was held to be taxable. It is also not the case that the Assessing Officer

decided the issue of admissibility of treaty benefits in favour of the assessee and that decision is now being put to scrutiny again. The Assessing Officer's action of not considering it expedient to look into the taxability of an income from all other possible angles cannot foreclose the examination of the taxability from different perspective. What is subject matter of dispute is not a facet of law but an income which is sought to be taxed. As long as the income, which is impugned in appeal, is same as assessed by the Assessing Officer, there cannot be any bar on considering any aspect of the legal position in this regard. Elaborating upon this aspect of the matter, a Special Bench of the Tribunal in the case of Tata Telecommunications Ltd Vs DCIT (121 ITD SB 384), has, inter alia, observed as follows :

> *……………It was bounden duty of the Tribunal to consider and decide the above issue and to examine that each of the condition specified by the section is satisfied…………. The position on this question, relating to power and jurisdiction of the Tribunal is more than clear as per decision of Allahbad High Court in the case of Phool Chand Gajanand vs. CIT 62 ITR 232 which has been applied by Full Bench of jurisdictional High Court in the case of Ahmedabad Electricity Co.Ltd. vs. CIT 199 ITR 351 (Bom.)(FB). Their Lordship have discussed in detail, as to how powers of the Tribunal are to be exercised. In the case of Hukumchand Mills Limited Vs CIT (63 ITR 232 SC), which has been followed by the Hon'ble Bombay High Court's Full Bench judgment in the case of Ahmedabad Electricity Co. Ltd (supra), Their Lordships of Hon'ble Supreme Court were in seisin of a situation in which it was argued before Their Lordships that "the Tribunal was not competent to go into the question whether the provisions of paragraph 2 of Taxation Laws Order were applicable to the present case and the respondent (i.e. the Revenue) should be allowed to raise this contention for the first time before the Tribunal". In essence, therefore, one of the qualifying condition, which was not considered by the Assessing Officer or Appellate Commissioner, was disputed for the first time before the Tribunal. It was in this background, and dealing with the powers of the Tribunal under section 33(4) of the 1922 Act, which are exactly the same as under section 254(1) of the present Income Tax Act, 1961, Hon'ble Supreme Court, inter alia, observed as follows:*

> *8. ……Tribunal had jurisdiction to permit the question to be raised before it for the first time in appeal. The power of the Tribunal, in dealing with the appeals are expressed in section 33(4) in the widest possible manner…….*
>
> *9. The word "thereon" in section 33(4) of the 1922 Act, of course, restricts the jurisdiction of the Tribunal to the subject matter of appeal. The words "pass such orders as the Tribunal think fit" include all the powers (except possibly enhancement) which are conferred on AAC under section 31. ……………..*
>
> *10. In the present case, the subject matter of appeal before the Tribunal was the question as to what should be the proper written down value of the building, machinery etc of the assessee for calculating depreciation under section 10(2)(vi) of the Act.*

16. The facts of the case before us are materially similar to the above case before the Hon'ble Supreme Court. In the present case also, the condition regarding providing eligible telecommunication services was not discussed by the Assessing Officer and the Commissioner (Appeals) and yet this issue was taken up by the Departmental Representative before us. The same was the situation in Hukumchand Mill's case (supra) wherein, as noted by the Hon'ble Supreme Court in paragraph 4 of their judgment, "it was urged before the Tribunal by the department that although the ITO had not considered the provisions of paragraph 2 of Section 2 of Taxation Laws Order, the said provisions were applicable in the present case and certain amounts of depreciation, which are allowed under the Industrial Tax Rules, which had the force of law in Indore State, were required to be deducted in arriving at written down value of the assets of the assessee". This plea was accepted by the Tribunal and the Hon'ble Supreme Court confirmed the action of the Tribunal in doing so. In this view of the matter, not only that admitting the plea regarding the assessee not rendering eligible telecommunication services does not suffer from any mistake apparent on record, but it does not suffer from any mistake at all. The stand so taken by the Tribunal is clearly in conformity with the law laid down by the Hon'ble Supreme Court. Once the Tribunal is called upon to examine as to whether or not the assessee is entitled to a claim of deduction, there is no escape from its duty to ensure that the requirements of section are fully complied with and the Tribunal cannot shun away

> *from its duty to examine all the eligible conditions merely on the ground that some of these conditions are not specifically rejected by the authorities below.*

32. It is noteworthy that, in terms of provision of Rule 11 of the Appellate Tribunal Rules 1963, while the appellant shall not, except by leave of the Tribunal, urge or be heard in support of any ground not set forth in the memorandum of appeal, the Tribunal, in deciding the appeal, shall not be confined to the grounds set forth in the memorandum of appeal or taken by leave of the Tribunal under this rule. The mandate of the rule is thus clear and unambiguous. While there are restrictions on the appellant as to the issues he can raise in the appeal, there are no restrictions on the Tribunal as to on what grounds the Tribunal decides the appeal. The only rider is, in terms of proviso to Rule 11, that " the Tribunal shall not rest its decision on any other ground unless the party who may be affected there by has had a sufficient opportunity of being heard on that ground". In effect thus, as long as affected parties have an opportunity of having been heard on the ground on which appeal is decided, the Tribunal can decide the appeal on any of the issue – whether raised by the parties or not. It is also important to appreciate that the expressions 'subject matter of appeal' and 'grounds of appeal' cannot be used interchangeably as they have distinct connotations. While the Tribunal cannot enlarge the scope of 'subject matter of appeal' inasmuch as a disallowance not made by any of the authorities below cannot be made by the Tribunal, or any addition of income not made by the authorities below cannot be made by the Tribunal, but, within the subject matter of appeal, the Tribunal can examine any aspect of the matter – whether the same has been examined by the authorities below or not. It is, thus, not only invitation of the parties but also on its own that the Tribunal can address itself to an aspect related to the issue in appeal, even though the same may not have been specifically raised by either of

the parties. The only limitation to this power perhaps is that it should not expand the scope of the appeal in terms of the income sought to be taxed or disallowance sought to be made, and that both the parties should have adequate opportunity of being heard on this issue in terms of the provisions of Rule 11 of the Appellate Tribunal Rules, 1963. As far as this aspect of the matter is concerned, we may usefully refer to the following observations and analysis of the legal position as made by a coordinate bench of this Tribunal, in the case of Morgan Stanley Asset Management Inc Vs DCIT (39 DTR 240) with which we are in respectful agreement :

> ***"………… When the assessee had itself repeatedly filed the returns in the capacity of AOP, how it can be argued that the Tribunal should close its eyes and ignore its mistake, which is manifest on the face of it. The Tribunal being a final fact finding authority cannot ignore such patent deficiencies. Moreover, the only question before us is to examine the validity or otherwise of the return. When we have to adjudicate upon this issue, all the aspects concerning it are open for inspection. It cannot be heard that the Tribunal has no power to consider the same question from a different angle. There is difference in raising a new dispute for the first time and considering a new aspect of the existing dispute. There is no impediment on its power to consider that very issue from a different angle. The Hon'ble Madras High Court in the case of CIT vs. Indian Express (Madurai) (P) Ltd. 140 ITR 705 has held that the Tribunal's jurisdiction is plenary in respect of questions of fact or law arising from assessment. The Tribunal is not precluded from examining a point for the first time merely because it has not been forwarded at the earlier stages of the proceedings. The Full Bench of the Hon'ble jurisdictional High Court in the case of Ahmedabad Electricity Co. Ltd. vs. CIT 199 ITR 351,has held that the Tribunal has jurisdiction to permit additional grounds to be raised before it even though these may not arise from the order of the AAC so long as these grounds are in respect of the subject-matter of the entire tax proceedings. Here is a case in which there is no question of any additional ground on an altogether different issue, but the consideration of the same issue from a different angle.***

20. Rule 11 of ITAT Rules, 1963 reads as under :

> ***"The appellant shall not, except by leave of the Tribunal, urge or be heard in support of any ground not set forth in the memorandum of appeal, but the Tribunal, in deciding the appeal, shall not be confined to the grounds set forth in the memorandum of appeal or taken by leave of the Tribunal under this rule :***
>
> ***Provided that the Tribunal shall not rest its decision on any other ground unless the party who may be affected there by has had a sufficient opportunity of being heard on that ground."***

(Emphasis supplied by us)

21. There can be no fetter on the power of the Tribunal to examine the subject-matter before it from different angle. As long as the subject-matter continues to remain the same, the Tribunal has sufficient power to examine it from any point of view. The Hon'ble Supreme Court in CIT vs. Mahalakshmi Textile Mills Ltd. 66 ITR 710 considered a case in which the Tribunal examined the true nature of Casablanca conversion system. The contention of the assessee that the introduction of Casablanca conversion system was of the nature of plant and machinery did not find favour with the Tribunal. It was held by the Hon'ble apex Court that : "The Tribunal rejected the claim of the assessee, but on that account the Tribunal was not bound to disallow the claim of the assessee for allowance of that amount spent if it was a permissible allowance on another ground. The Tribunal, on investigation of the true nature of the alterations made by the introduction of the Casablanca conversion system, came to the conclusion that it did not amount to installation of new machinery or plant, but it amounted in substance to current repairs to the existing machinery. The subject-matter of the appeal in the present case was the right of the assessee to claim allowance for Rs. 93,215. Whether the allowance was admissible under one head or the other of sub-s. (2) of s. 10, the subject-matter for the appeal remained the same and the Tribunal having held that the expenditure incurred fell within the terms of s. 10(2)(v), though not under s. 10(2)(vib), it had jurisdiction to admit that expenditure as a permissible in the computation of the taxable income of the assessee." Similar view has been expressed by several other High Courts holding that the power of

the Tribunal extends to examining the subject-matter of appeal from any perspective, In the following cases where disallowance of expenses was made by the Revenue under one section, the Hon'ble High Courts have held that the Tribunal has the power to uphold the disallowance under another section. It has further been laid down that the Tribunal did not go outside the subject-matter of the appeal when it sustained disallowance on the same issue but under some different provision :

(i) Steel Containers Ltd. vs. CIT 112 ITR 995
(ii) P. Ibrahim Haji vs. CWT 232 ITR 253

22. In the backdrop of the present factual matrix, we are not inclined to agree with the viewpoint of the learned Authorised Representative that the Tribunal's hands are tied for examining the validity of the return from a fresh angle. It is axiomatic that the subject-matter of the appeal is the validity or otherwise of the return. When some facts are open to the naked eye, which have bearing on the subject-matter, it cannot be heard that the Tribunal should act as a mute spectator and let the wrong prevail. In view of the foregoing legal position emanating from the judicial pronouncements and the latter part of r. 11 of ITAT Rules, we are of the considered opinion that there is no jumping of power by us in examining the validity of return from the above angle after specifically putting across the assessee with this point of view and allowing it to make submissions in this regard.

23. Insofar as the reliance of the learned Authorised Representative on certain decisions on the question of putting the assessee in an adverse position is concerned, we find that raising this query does not have the effect of putting the assessee in an adverse position in as much as both the authorities below have held the returns to be invalid. We are hearing the appeal of the assessee on the validity of the returns filed by it. Thus, the only question is the examination of the validity of the return from another angle. The upper limit of harm to be caused to the assessee is that the invalidity will sustain, the position in which the assessee is already sitting in. There is not going to be any enhancement by our action, as has been contended on behalf of the assessee.

24. Although our action is not going to result into any enhancement, but still when the issue has been raised by the

learned Authorised Representative that the Tribunal can neither examine this aspect itself nor restore the matter to the AO for proper adjudication from this angle, we want to make it clear that there is no such bar on the Tribunal in restoring the matter to the file of AO even though it may result in enhancement. Hon'ble Supreme Court in CIT vs. Assam Travels Shipping Service 199 ITR 1 has held as under:

> *"The AAC as well as the Tribunal clearly held that the computation of penalty made by the ITO was not in accordance with law and that the correct computation of penalty was also made while taking that view. The conclusion clearly reached was that the computation of penalty had to be made in accordance with s. 271(1)(a) r/w sub-s. (2) of s. 271. The correct figure arrived on that basis on the facts of this case was also indicated. On that conclusion, the only question arising out of the Tribunal's order was whether the Tribunal had no other alternative except to dismiss the Department's appeal and thereby affirm the order of the AAC cancelling even the lesser penalty imposed by the ITO overlooking s. 271(2). The expression 'as it thinks fit' is wide enough to include the power of remand to the authority competent to make the requisite order in accordance with law in such a case even though the Tribunal itself could not have made the order enhancing the amount of penalty. The power of the AAC under s. 251(1)(b) includes the power even to enhance the penalty subject to the requirement of sub-s. (2) of s. 251 on a reasonable opportunity of showing cause against such enhancement being given to the appellant assessee. This could have been done in the assessee's appeal itself filed in the present case. The Tribunal was not justified in taking the view that it had no other alternative except to affirm the order of the AAC cancelling even the lesser penalty imposed by the ITO. In view of s. 251(1)(b), it is also clear that the AAC was wrong in taking the view that he had no power to enhance the penalty in accordance with law on reaching the conclusion that the computation of penalty made by the ITO was illegal, and that he could only cancel even the lesser penalty which had been imposed by the ITO."*

25. In view of the above discussion we are satisfied that there is no substance in the submission made on behalf of the assessee

> ***that the Tribunal cannot examine the validity of the return from the point on which clarification was sought from the learned Authorised Representative. We are, therefore, proceeding to dispose of the issue on merits.***

33. In view of the above discussions, and respectfully following the esteemed views of the coordinate bench, we reject the preliminary objection raised by the learned counsel, and proceed to deal with the core question whether or not a partnership firm based in United Kingdom is entitled to the benefits of the India UK tax treaty.

34. Let us first take a look at the relevant provisions of the India UK tax treaty so gas as the question of treaty entitlement is concerned:

> ***Article 1 - Scope of the Convention***
>
> ***(1) This Convention shall apply to persons who are residents of one or both of the Contracting States.***
>
> ***Article 3 - General definition***
>
> ***(2) A partnership which is treated as a taxable unit under the Income-tax Act, 1961 (43 of 1961) of India shall be treated as a person for the purposes of this Convention.***
>
> ***Article 4 - Fiscal domicile***
>
> ***(1) For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the law of that State, is liable to taxation therein by reason of his domicile, residence, place of management or any other criterion of a similar nature.***

35. We find that in terms of Article 1 (1), the India UK tax treaty "shall apply to persons who are residents of one or both of the Contracting States". As to what are the connotations of expression

"resident of a contracting state", Article 4(1) of the treaty provides that, for the purposes of the said tax treaty, term 'resident of a Contracting State' " means any person who, under the law of that State, is liable to taxation therein by reason of his domicile, residence, place of management or any other criterion of a similar nature." It is thus necessary that the resident can only be 'person' and that person should be 'liable to taxation by reasons of his domicile, place of management or any other criterion of similar nature'. It is also important to bear in mind the fact that in terms of provisions of Article 3(2), "a partnership which is treated as a taxable unit under the Income-tax Act, 1961, of India shall be treated as a person" for the purposes of this treaty. To the extent that a partnership is required to be treated as a person, thus, the position is free from any doubt or ambiguity.

36. The controversy, however, revolves around second limb of definition under article 4(1) which requires 'person' to be 'liable to taxation by reasons of his domicile, residence, place of management or any other criterion of similar nature'.

37. It is interesting to note that, in terms of report commissioned by the Organization of Economic Cooperation & Development (OECD, in short), titled 'The application of OECD Model Convention to Partnerships – 1999', mere computation of income at the level of partnership, as has been done on the facts of present case, is not sufficient to hold that the partnership firm is 'liable to taxation' in the residence country. The said report, in paragraph 40, states as follows:

> ***…………………for the purposes of determining whether the partnership is liable to tax, the real question is <u>whether the amount of tax payable on the partnership income is determined in relation to the personal characteristics of the partners</u>. If the***

answer to this question is yes, then the partnership itself would not be considered liable to tax. The fact that the income is computed at the level of partnership, before being allocated to the partners, that the tax is technically paid by the partnership or that it is assessed on partnership will not change that result.

(Emphasis supplied by us)

38. As we mention about the above OECD report, and also proceed to deal with the background in which the expression 'liable to tax' is required to be construed, it is useful to stand back for a moment and reflect on the issue, of treaty entitlements to partnerships, in general terms, and the reasons for which it hogged so much of limelight and controversy. That understanding should help us understand the issue requiring our adjudication in proper perspective.

39. In its simplest form, the problem is of asymmetrical taxation of an entity, in respect of its cross border income, in its source and residence tax jurisdictions. While taxing income attributable to a foreign entity, the source country has to first decide as to how such foreign entity should be treated for domestic tax law purposes of the source country, i.e. the exercise of 'foreign entity classification'. These classifications for the purposes of taxation, or the manner in which the taxpayers falling under that classification are taxed, need not be homogenous in the treaty partner countries. Let us consider a situation in which an entity is treated as opaque, and taxed as such, in one jurisdiction, and as fiscally transparent, and disregarded as such, in the other jurisdiction. While in the first jurisdiction, the entity will be taxed in its own right, and the second jurisdiction, i.e. where it is disregarded and treated as transparent, the taxability will be in the hands of the owners. That results

in a situation that while there is no juridical double taxation of an income, there is undoubtedly economic double taxation of an income. Take, for example, a situation in which a partnership firm is treated as an opaque entity in the source jurisdiction and taxed as such in respect of profits of the partnership in the source jurisdiction, but the same firm is treated as a fiscally transparent entity in the residence jurisdiction and the taxability of income, in the residence jurisdiction, arises only in the hands of the partners of the partnership firm.

40. This incongruity arises because of the fact that mechanism of relieving a taxpayer of double taxation in respect of cross border income typically takes care of international juridical double taxation i.e. the same income getting taxed twice – in the source jurisdiction as also in residence jurisdiction – in the hands of the same taxpayer. An economic double taxation of an income, on the other hand, which refers to taxability of same cross border income in the hands of different taxpayers, is not directly addressed by the tax treaties. The other important issue is the mechanism of relieving this economic double taxation, and it is in this respect that the OECD has prepared the 'The application of OECD Model Convention to Partnerships – 1999' which has also lead to changes in the Model Convention Commentary.

41. The question then arises whether the tax treaties are at all required to deal with the issue of economic double taxation of this nature, and provide remedy for relieving taxpayers of such economic double taxation, or whether the role of treaties is confined to relieving the taxpayers only juridical double taxation.

42. On a conceptual note, the fundamental purpose of tax treaties, and even unilateral rules for double taxation reliefs, is ensure that cross

border economic activity, which is perceived as an essential factor for prosperity of the world economy, is not hindered by ill effects of subjecting the same economic activity to taxation in more than one tax jurisdiction. This problem also arises because of the inherent conflict and overlapping effect of scope of taxation laws being followed by the source and residence jurisdiction. When tax laws of partner tax jurisdictions are applied to a tax object, the results are not harmonious. Tax treaties seek to lay down the rules so as to reconcile between these competing claims of taxability on a tax object. The cause of economic double taxation due to asymmetrical taxation is also somewhat similar, and it is a result of inherent conflict between different treaty classification rules followed by the source and residence tax jurisdictions. If this is not reconciled, it will also result in a situation that same tax object will get taxed twice. However, the rules of reconciliation in the case of differences in treaty classification are not as neatly laid down in the tax treaties. The rules not having been laid down does not imply that the glaring incongruity is to be treated as a tolerable evil. OECD efforts to resolve this problem, which are demonstrated by publication of its report 'The Application of OECD Model Convention to Partnerships' and subsequent changes to OECD Model Commentary, also show that it is well within the scope and intention of tax treaties to aim at resolving economic double taxation caused by asymmetrical tax treatment and entity classification. It does not, therefore, seem to be beyond the fundamental objectives of a tax treaty to relive the economic double taxation of an income a situation in which such economic double taxation arises due to asymmetrical tax treatment of a business entity.

43. Coming back to the fundamental issue that we need to deal with, i.e. whether or not the partnership firm before us is entitled to the benefits of the India UK tax treaty, we have noted that the controversy is

confined to whether or not the assessee can be said to be 'liable to taxation *(in UK)* by reasons of his domicile, residence, place of management or any other criterion of similar nature' so as to qualify as a resident of UK, and, in turn, be eligible for benefits of the tax treaty. While the issue of treaty benefits eligibility of partnership firms has not come up for specific adjudication before the Indian judicial authorities, the judicial authorities, in several cases, have proceeded on the basis that the partnership firms are eligible for treaty benefits. As held by Hon'ble Bombay High Court in the case of CIT Vs Sudhir Jayantilal Mulji (214 ITR 154), 'a judicial precedent is an authority for what it actually decides and not what may come to follow from some observations which may find place therein'. The propositions, which are assumed by the Court to be correct for the purpose of deciding a question, are, according to this judgment of the Hon'ble jurisdictional High Court, lack precedence value and are not binding in nature. No judicial precedent, dealing with the question as to whether or not partnership firms are entitled to treaty benefits, has been brought to our notice, nor are we aware of any such domestic judicial precedent. Learned counsel's reliance on Hon'ble Bombay High Court's judgment in the case of Clifford Chance (supra) is thus of no avail so far as the issue of treaty entitlements to partnership firms is concerned.

44. There are, however, a few decisions from foreign Courts which touch upon the issues relating to entitlement of a transparent entity to the tax treaty benefits.

45. In J J Grudlingh's case (supra), Free State High Court Bloemfontein , in South Africa, has held that the treaty benefits cannot be extended to the partnership firms. However, as learned counsel has successfully demonstrated to us, there are indeed some significant

peculiar facts, which restrict this decision from being of relevance in the facts before us. As learned counsel rightly points out and as evident from reading the text of the said judgment, that was a case in which 'person', as defined under Article 3(1)(i) of South Africa Lesotho tax treaty, was only to include an individual, a company or "any other body of person which is termed as an entity for the tax purposes *(emphasis supplied by us by underlining)*" whereas the partnership firm in question was admittedly not a entity for tax purposes. Learned counsel is also right in observing that it was thus not a situation in which taxation of firm was asymmetrical in the partner tax jurisdiction. The judgement itself notes, in paragraph 10.5, "It is a common cause that a partnership is not a person or legal entity both in South African and the Kingdom of Lesotho". That situation is materially different vis-à-vis the situation that we are *in seisin* of in which a partnership firm regarded as a tax entity under the Indian Income Tax Act, under Article 3(2), is specifically covered by the definition of 'person'. This judicial precedent from South Africa is thus of little use to us.

46. In the case of TD Securities (USA) LLC Vs Her Majesty the Queen [2010 TCC 186; IBFD tax treaty case law database reference Canada-2008-2314(IT)G], Tax Court of Canada had an occasion to deal with the question of treaty entitlements to transparent entities.

47. Although the taxable entity in this case was not a partnership firm, the taxable entity was a fiscally transparent entity under the US laws and the income of the said entity was entirely taxable, in its residence country i.e. USA, in the hands of its ultimate owner member i.e. TD Holdings (II) Inc., and yet it was held to be eligible, in Canada, for treaty benefits of Canada US tax treaty.

48. Interestingly, in this case, the stand of the revenue authorities was the same, as before us, as evident from the observation of the court to the effect that “It is the respondent’s position that the meaning of the phrase resident of a Contracting State set out in the US Treaty is clear and unambiguous and that the evidence is clear that TD LLC was not itself liable to tax in the US”, that “The respondent maintains that the meaning of the language chosen by two countries to define to whom the US Treaty applies cannot be interpreted in a manner which will entitle TD LLC to the benefits of the treaty without either ignoring some of the words used or reading some words into it., and that “As the respondent argued, treaties should be interpreted liberally and purposively but, in the end, effect must be given to the words chosen”.

49. It is not really required of us to set out the factual matrix of this case in complete detail. Suffice to take note of the position that the appellant in this case i.e. TD Securities (USA) LLC was a Delaware corporation, covered by Limited Liability Company Act in the State of Delaware (USA), with a single member as TD Holdings II Inc which was assessed to tax in USA. These single member Delaware corporations seem to be somewhat unique in the sense that while these corporations are distinct from its member, it is only at the choice of the corporation that these corporations are treated as taxable units. It appears that as the appellant did not file election under the “check the box regulation” it was treated as a disregarded entity for the US tax purposes and all its income was taxable to TD Holding II Inc. There was thus no dispute that TD Securities (USA) LLC was not taxed in its own capacity and was not liable to pay tax; tax liability in respect of its entire income was assessed to TD Holdings II Inc. On these facts, the question arose, whether TD Securities USA LLC could be treated as eligible for Canada US tax treaty benefits, which, in turn required the assessee to be ‘liable to taxation (*in USA)* by

reasons of his domicile, residence, citizenship, place of management or any other criterion of similar nature'. The short issue thus was whether or not a person, who does not pay tax in the residence state, in his own capacity and in respect of its income, can be said to be covered by the scope of expression, as set out in Article IV of Canada US tax treaty (with addition of word 'citizenship') and as is set out in Article 4(1) of India UK tax treaty which requires 'person' to be 'liable to taxation by reasons of his domicile, residence, place of management or any other criterion of similar nature'. On this issue, the Court, inter alia, concluded as follows:

> ***………The US Code provides that the income of TD LLC is fully and comprehensively taxed to its member, Holdings II. This income is consolidated in the TD USA tax return and tax thereon is charged back by TD USA to TD LLC…………In such a case, it seems clear that the income of TD LLC should enjoy the benefits of the US Treaty. The evidence is overwhelming that the object and purpose of the US Treaty read in the context of all of the evidence and authorities would not be achieved and would be frustrated if the Canadian sourced income of TD LLC that is fully taxed in the US under the US Code does not enjoy the benefits of the US Treaty including Article X(6).***

50. While deciding the above question Hon'ble Justice Patrick Boyle, delivering a very elaborate judgment of the court dealing with several facets of this question – though mainly in the context of aspects relating to Canada US tax treaty, Canadian and US tax policies and peculiarities of Delaware single member corporations, also set out the principles on the basis of which the above question is to be answered. Justice Boyle observed, inter alia, as follows:

> ***[50] The Vienna Convention on the Law of Treaties provides that a treaty is to be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of its object and purpose. It also authorizes regard to subsequent practice in the application of the treaty in***

certain circumstances and for certain purposes, as well as the use of other supplementary means of interpretation when the interpretation of the treaty otherwise leads to a result which is manifestly absurd or unreasonable.

[51] It is fair to say that in this case there is a tension between the ordinary meaning of the terms used in the treaty and its object and purpose. This is a case where it prima facie appears that a strict application of the terms used to define resident of a Contracting State leads to an unreasonable result and thus, regard to supplementary means of interpretation is an appropriate part of the required analysis. The prima facie unreasonableness is demonstrated by, amongst other things, the fact that a strict application of the text would conflict with how both countries have interpreted and applied the treaty to government entities, not for profit organizations, pension funds and, as described below, partnerships which are themselves also fiscally transparent flowthrough entities.

[52] In The Queen v. Crown Forest Industries Limited et al., 95 DTC 5389, the Supreme Court of Canada had occasion to consider the appropriate interpretation to be given to the phrase "resident of a Contracting State" in Article IV of the US Treaty and, in particular, what it meant to be "liable to tax" in the US by reason of the enumerated criteria.

[53] The Court began from the premise that: "In interpreting a treaty, the paramount goal is to find the meaning of the words in question. This process involves looking to the language used and the intentions of the parties." The Court went on to quote approvingly from Addy J. in Gladden Estate v. The Queen, 85 DTC 5188, wherein he wrote at p. 5191: Contrary to an ordinary taxing statute a tax treaty or convention must be given a liberal interpretation with a view to implementing the true intentions of the parties. A literal or legalistic interpretation must be avoided when the basic object of the treaty might be defeated or frustrated insofar as the particular item under consideration is concerned.

[54] Both the Vienna Convention and the Supreme Court of Canada in Crown Forest confirm that "literalism has no role to play in the interpretation of treaties": Coblentz v. The Queen, 96 DTC 6531 (FCA).

[55] In Crown Forest the Supreme Court of Canada also held that, in ascertaining the purposes of a treaty article, a court may refer to extrinsic materials which form part of the legal context, including model conventions and official commentaries thereon, without the need to first find an ambiguity before turning to such materials.

[56] The Preamble to the US Treaty sets out its purposes of reducing or eliminating double taxation of income earned by a resident of one country from sources in the other country, and of preventing tax avoidance or evasion. In Crown Forest the Supreme Court of Canada held that the purposes of the US Treaty also included the promotion of international trade between the two countries and the mitigation of administrative complexities arising from having to comply with two uncoordinated taxation systems.

[57] In Canada Trustco Mortgage Co. v. Canada, 2005 SCC 54, 2005 DTC 5523, the Supreme Court of Canada emphasized that "[t]he provisions of the Income Tax Act must be interpreted in order to achieve consistency, predictability and fairness so that taxpayers may manage their affairs intelligently." This Court sees no reason why the objectives of consistency, predictability and fairness should be any less in the case of the interpretation and application of international tax conventions forming part of applicable Canadian income tax law.

[58] On the substantive issue of the meaning of the phrases resident of a contracting state and liable to tax by reason of the enumerated criteria, the Supreme Court of Canada in Crown Forest clearly concluded that the definition sought to describe those who are subject to as comprehensive a tax liability as is imposed by a state, which in the US as in Canada is taxation on worldwide income. The Court was not faced in Crown Forest with circumstances where one person's worldwide income was subject to tax in the hands of another related entity resident in the same jurisdiction by virtue of specific US domestic taxing rules. It is nonetheless a strong confirmation that the intended purpose and scope of Articles I and IV of the US Treaty were that the treaty apply to those bearing full tax liability in either of the contracting states based upon the nature and extent of their connections with that country.

51. While this decision cannot be an authority for the proposition that partnership firms or fiscally transparent entities must always be extended treaty benefits available to other taxable entities domiciled in that tax jurisdiction, this decision does certainly support the theory that it is fact of taxability of income in the residence state, rather than modality of such taxation, which must have greater relevance, and that the tax treaties ought to be interpreted on a contextual basis rather than on the basis of strict principles of interpretation of tax laws.

52. Let us try to find contextual meaning of the term 'liable to tax by reasons of his domicile, residence, place of management or any other criterion of similar nature'. There could be several reasons for which a person may be liable to tax in a tax jurisdiction, such as source based taxation of an income, a presumptive tax in respect of an offshore business, or simply a tax because of a physical presence, such as by of a liaison office, in a tax jurisdiction, or because of a locality related attachment which leads to residence based taxation. The taxation of a person in all these situation does not necessarily indicate a fiscal domicile in that jurisdiction. In our considered view, in its contextual sense, expression 'liable to tax by reasons of his domicile, residence, place of management or any other criterion of similar nature' refers to a situation in which a person is liable to tax in a tax jurisdiction by the virtue of a locality related attachment which leads to residence type taxation. While elaborating upon the scope of this expression, a coordinate bench of this Tribunal, in the case of DCIT Vs General Electric Co plc (2001) 71 TTJ 973 had observed as follows:

> ………..Art. 4(1)* ….clearly provides that "for the purpose of this Convention, the term 'resident of one of the states' means any person who, under the laws of that state, is liable to taxation therein by reasons of his domicile, residence, place of management

or any other criterion of a similar nature". The requirements for fiscal domicile cannot be satisfied by mere liability to tax in that country, but as clearly provided by art. 4(1) ……, such a liability to taxation has to be on account of domicile, residence, place of management or any other criterion of a similar nature. The question, then, is as to what are the connotations of these terms and whether source taxability of dividend income per se can generate 'treaty entitlements' of the country in which such taxes on dividends have been paid. The wordings of art. 4(1) leave no doubt about the fact that merely because a person is tax-payer in one of the countries which are party to the (tax treaty)………, such a person cannot be treated as 'resident of one of the states' for the purposes of the DTAA. ……… No. doubt, as observed by Dr. Klaus Vogel in his Commentary to the Double Taxation Conventions, the term 'other criterion of similar nature' makes clear that the enumerated criterion of domestic law which attracts tax liability are no more than examples for the rule, but Dr. Vogel has further stated that, "The term should be understood to mean any locality-related attachment that attracts residence-type taxation." An illustration given in this commentary refers to "statutory seat which, under German law, serves as an alternative point of attachment in the absence of a place of management within the domestic territory." We are in considered agreement with Dr. Vogel's observation that 'any other criterion of similar nature' should be understood to mean any locality related attachment that attracts residence type taxation. **In the light of these discussions, it is clear that only 'locality related attachment which lead to residence type taxation' ('locality related' being the genus to which expressions 'domicile' 'residence' and 'place of effective management' belong) can be covered by the scope of expressions 'any other criterion of similar nature' in terms of art. 4(1)** ……..

*of the Indo-Dutch DTAA
[which is the same as Article 4(1) of India UK tax treaty that we are dealing with at present]

53. We are in considered agreement with the views so expressed by the coordinate bench. The common thread in all the factors which have decisive role to play in determination of fiscal domicile is that these

factors consist of some locality related attachment of the person which leads to residence type, i.e. full fledged and not in respect of a limited source, taxation of that person.

54. Let us take a hypothetical example to illustrate application of this principle. There are occasions when a business entity has to pay taxes on its income in more than one tax jurisdiction. Take, for example, a company, incorporated and fiscally domiciled in X tax jurisdiction, which has income generating activities in A,B,C and D tax jurisdictions. It has a royalty income sourced from 'A' tax jurisdiction, so it is liable to tax in 'A' jurisdiction in respect of royalty income sourced from there. It has a liaison office in 'B' tax jurisdiction, and it is liable to pay municipal trade tax in respect thereof in B tax jurisdiction. The same organization has permanent establishments in C and D tax jurisdictions, and, therefore, it is liable to pay taxes in respect of the profits of the PE in C and D tax jurisdictions. As a fiscal resident of X tax jurisdiction, however, it is also liable to pay tax on all its incomes, whether sourced from A,B,C,D or X itself or from any other tax jurisdiction, in X tax jurisdiction. In this example, while the related business organization is liable to tax in A,B,C,D and X jurisdictions, it is taxable by the reason of 'domicile, residence, place of management or such other criterion of similar nature' only in X jurisdiction. It is in this sense that being liable to tax in a contracting state is not sufficient, the liability for such taxation has to be on account of a locality related attachment which leads to residence type taxation as the expression "by the reason of domicile, residence, place of management or such other criterion of similar nature" indicates.

55. What follows thus is that in order that person in one of the contracting states entitles himself to treaty benefits in the other contracting state, income of that person should be subjected to residence

type taxation, on account of some locality related attachment, in that contracting state.

56. Modalities or mechanism of taxation may vary from jurisdiction to jurisdiction, as domestic law is a sovereign function and a bilateral tax treaty, or even the need of uniformity in entity classification approach - no matter how desirable someone may consider it to be, does not dictate such modalities of taxation being legislated. The fact of taxation, however, can be decided in an objective and uniform manner. Take, for example, a situation, in which the residence country of partnership does not regard it as a taxable unit and the entire income from partnership is taxed in the hands of the persons constituting such partnership, and some of those partners are not even residents of the tax jurisdiction in which partnership firm is resident. In such a situation, in case partnership firm seeks treaty protection from the other contracting state, it could possibly be argued that income of the partnership firm is not entirely taxable even in the contracting state in which partnership firm has fiscal domicile, and, therefore, the income of the partnership was not taxed in the residence state. However, in a situation in which entire income of the partnership firm is taxed in the residence country – whether in its own hands or in the hands of the partners – this objection can hardly be taken. From a country perspective, what really matters is whether the income, in respect of which treaty protection is being sought, is taxed in the treaty partner country or not. That is the clearly the underlying principle based on which residence definition is modeled.

57. The treaty developments around the globe, for example by way of 2007 amendments in US Canada tax treaty by way of fifth protocol to that treaty, which specifically provides that even a transparent tax entity will qualify for treaty entitlement, confirm this approach. This

amendment specifically addresses how the Canada US tax treaty applies to fiscally transparent treaties such as partnerships and LLCs. Of course, the Canadian Tax Court has expressed, in no uncertain words, the view that even without the aforesaid amendment, a fiscally transparent entity is eligible for treaty benefits in the country of domicile as long as its profits get taxed in that country, and the amendment only grants, or rather restricts, application of an existing benefit. That is what was also held in TD Securities case (supra), but, for the present purposes, what is even more important that some tax jurisdictions, on their own, are consciously interpreting the 'liable to taxation' in such a pragmatic manner as to extend treaty benefits to fiscally transparent entities.

58. We are alive to the fact that the Canadian Tax Court decision, in the case of TD Securities (USA) LLC (supra), related only to the period prior to the said amendment as the protocol amendment was not taken as retroactive. The amendment was done by adding two paragraphs in Article IV of the Canada US tax treaty, and one of the arguments of the revenue authorities before the Court was that grant of treaty benefits to the fiscally transparent tax entities, prior to the fifth protocol amendment, would render the amendment infructuous because the taxpayers will be eligible for treaty entitlements even without fulfilling the conditions set out for such benefits in the amendment. The Court saw the amendment as a limitation placed by the treaty, as evident from their observation that, "The Court recognizes a certain irony in the fact that its decision in this case has been, on a prospective basis, statutorily overridden prior to it having been decided". The two paragraphs which were inserted in Article IV, by the protocol amendments and which were seen as restricting the applicability of Canadian decision, were as follows:

6. An amount of income, profit or gain shall be considered to be derived by a person who is resident of a Contracting State where:

(a) The person is considered under the taxation law of that State to have derived the amount through an entity (other than an entity that is a resident of the other Contracting State); and

(b) By reason of the entity being treated as fiscally transparent under the laws of the first mentioned State, the treatment of the amount under the taxation law of that State is the same as its treatment would be if that amount had been derived directly by that person.

7. An amount of income, profit or gain shall be considered not to be paid to or derived by a person who is a resident of a Contracting State where:

(a) The person is considered under the taxation law of the other Contracting State to have derived the amount through an entity that is not a resident of the first mentioned State, but by reason of the entity not being treated as fiscally transparent under the laws of that State, the treatment of the amount under the taxation law of that State is not the same as its treatment would be if that amount had been derived directly by that person; or

(b) The person is considered under the taxation law of the other Contracting State to have received the amount from an entity that is a resident of that other State, but by reason of the entity being treated as fiscally transparent under the laws of the first mentioned State, the treatment of the amount under the taxation law of that State is not the same as its treatment would be if that entity were not treated as fiscally transparent under the laws of that State.

59. A plain reading of the judgment of Canadian Tax Court in the case of TD Securities (supra) does show that the above amendment in the treaty position was more of a restriction on the treaty entitlements benefits to a fiscally transparent entity rather than the sole basis for the treaty entitlement benefit.

60. It would, therefore, seem logical that it is the event of taxability in the residence state, rather than the mode of taxability there, which should be a decisive factor for determining whether the person should be treated as eligible for treaty benefits of the contracting state in which he claims to be resident, but then while interpreting a tax treaty, is it really open to us to address ourselves to the rationale and objective of a tax treaty and disregard the plain words of the treaty? Does the context in which this expression is used in the tax treaty require a rather legalistic or somewhat liberal view of this expression? Are we to read the words used in a tax treaty in a mechanical manner or we are to give effect to the same in the light of the underlying, but clearly discernible, scheme of tax treaty?

61. Elaborating upon the principles governing interpretation of tax treaties, Lord Denning in Bulmer Limited v. S. A. Bollinger (1972) 2 All ER 1226, has observed:

> ***"........... The treaty .... is quite unlike any of the enactments we have been accustomed. .... It lays down general principles. It expresses aims and purposes .... what are English Courts to do when they are faced with a problem of interpretation ? They must follow the European pattern. No longer must they examine the words in meticulous detail. No longer must they argue about the precise grammatical sense. They must look to the purpose or intent ...."***

62. Echoing these views and justifying his departure from the plain meaning of the words used in the treaty, Goulding J., in IRC v. Exxon Corporation (1982) STC 356 at p. 359, observed:

> ***"In coming to the conclusion, I bear in mind that the words of the convention are not those of a regular Parliamentary draughtsman but a text agreed on by negotiations between the***

> ***two Contracting Governments. Although I am thus constrained to do violence to the language of the Convention, I see no reasons to inflict a deeper wound than necessary. In other words, I prefer to depart from the plain meaning of language only in the second sentence of art. XV and I accept the consequence (strange though it is) that similar words mean different things in the two sentences."***

63. In a later judgment, Harman, J. in Union Texas Petroleum Corporation v. Critchley (1988) STC 69, affirmed the above observations of Goulding, J. and added :

> ***"I consider that I should bear in mind that this double tax agreement is an agreement. It is not a taxing statute, although it is an agreement about how taxes should be imposed. On that basis, in my judgment, this agreement should be construed as ut res magis valeat quam pereat, as should all agreements. The fact that the parties are 'high contracting parties', to use an old description, does not change the way in which the Courts should also approach the construction of any agreement."***

64. We are in considered agreement with this school of thought which lays down the proposition that, strictly speaking the principles of literal interpretation do not apply to the interpretation of tax treaties. To find the meaning of words employed in the tax treaties, we have to primarily look at the ordinary meanings given to those words in that context and in the light of its objects and purpose. Literal meanings of these terms are not really conclusive factors in the context of interpretating a tax treaty which ought to be interpretated in good faith and ***ut res magis valeat quam pereat***, i.e., to make it workable rather than redundan

65. Hon'ble Supreme Court in the case of Union of India & Anr. v. Azadi Bachao Andolan & Am. 263 ITR 706, had an occasion to deal with the principles governing the interpretation of tax treaties. In this regard,

Hon'ble Supreme Court held that the principles adopted in the interpretation of treaties are not the same as those adopted in the interpretation of statutory legislation. Their Lordships quoted, with approval, following passage from the Judgment of the Federal Court of Canada in the case of IV. Gladden v. Her Majesty the Queen 85 DTC 5188, at p. 5190, wherein the emphasis is on the 'true intentions' rather than 'literal meaning of the words employed' :

> ***"Contrary to an ordinary taxing statute, a tax treaty or convention must be given a liberal interpretation with a view to implementing the true intentions of the parties. A literal or legalistic interpretation must be avoided when the basic object of the treaty might be defeated or frustrated insofar as the particular items under consideration are concerned."***

66. In the said judgment, as noted by Their Lordships at p. 743, the Federal Court of Canada recognized that "*we cannot expect to find the same nicety or strict definition as in modern documents, such as deeds, or Acts of Parliament, it has never been habit of those engaged in diplomacy to use legal accuracy but rather to adopt more liberal terms*".

67. In Azadi Bacahao Andolan's case (supra), Their Lordships also quoted with approval, Fancis Bennion's certain observations in his work Statutory Interpretation (Butterworths, 1992 Edn. at p. 461). Extracts from the said observations are as follows :

> ***"With indirect enactment, instead of the substantive legislation taking a well known form of an Act of Parliament, it has the form of a treaty. In other words, form and language found suitable for embodying an international agreement, at the stroke of a pen, also the form and language of a municipal legislative instrument. It is rather like saying that, by Act of Parliament, a woman shall be a man. Inconveniences may ensue.***

One inconvenience is that the interpreter is likely to be required to cope with disorganised composition instead of precision drafting ....

.... The interpretation of a treaty imported into municipal law by indirect enactment was described by Lord Wilberforce as being 'unconstrained by technical rules of English law, or by English legal precedent, but conducted on the broad principles of general acceptation'. This echoes optimistic dictum of Lord Widgery, C.J. that the words 'are to be given their general meaning, general to lawyer and laymen alike ...... the meaning of diplomat rather than the lawyer'."

68. Hon'ble Supreme Court, in the case of K. P. Varghese v. Income Tax Officer (131 ITR 597) and even in this context of interpretation of taxing statutes, have held that the task of interpretation is not a mechanical task and, quoted with approval Justice Hand's observation that "it is one of the surest indexes of a mature and developed jurisprudence not to make a fortress out of the dictionary but to remember that statutes always have some purpose or object to accomplish, whose sympathetic and imaginative discovery is the surest guide to their meaning". Their Lordships observed as follows :

".............. The task of interpretation of a statutory enactment is not a mechanical task. It is more than a mere reading of mathematical formulae because few words possess the precision of mathematical symbols. It is an attempt to discover the intent of the legislature from the language used by it and it must always be remembered that language is at best an imperfect instrument for the expression of human thought and, as pointed out by Lord Denning, it would be idle to expect every statutory provision to be 'drafted with divine prescience and perfect clarity'. We can do no better than repeat the famous words of Judge learned Hand when he said :

'... it is true that the words used, even in their literal sense, are the primary and ordinarily the most reliable source of interpreting the meaning of any writing : be it a statute, a contract or anything else. But it is one of the surest indexes of a

> ***mature and developed jurisprudence not to make a fortress out of the dictionary; but to remember that statutes always have some purpose or object to accomplish, whose sympathetic and imaginative discovery is the surest guide to their meaning.'***
>
> ***We must not adopt a strictly literal interpretation of .... but we must construe its language having regard to the object and purpose which the legislature had in view in enacting that provision and in the context of the setting in which it occurs. We cannot ignore the context and the collocation of the provisions in which .... appears, because, as pointed out by Judge Hand in the most felicitous language : interpret .... the meaning of a sentence may be more than that of the separate words, as a melody is more than the notes, and no degree of particularity can ever obviate recourse to the setting in which all appear, and which all collectively create ....***

69. When such are the views of the Hon'ble Supreme Court on the interpretation of taxing statutes, essentially the tax treaties, which are to be subject to much less rigid rules of interpretation, cannot be subjected to literal interpretation in isolation with the objects and purpose for which those provisions are made.

70. In the case of Hindalco Industries Ltd Vs ACIT (94 ITD 242) this Tribunal had an occasion to set out the principles on the basis of which tax treaties are to be interpretated. Summarizing these principles, this Tribunal has observed as follows:

> **The school of thought emerging from the above discussions leads us to conclude that the principles governing interpretation of tax treaties can be broadly summed up as follows:**
>
> - **A tax treaty is an agreement and not taxing statute, even though it is an agreement about how taxes are to be imposed. The principles adopted in the interpretation of statutory legislation are not applicable in interpretation of treaties.**

- **A tax treaty is to be interpreted in good faith in accordance with the ordinary meaning given to the treaty in the context and in the light of its objects and purpose.**

- **A tax treaty is to required to be interpreted as a whole, which essentially implies that the provisions of the treaty are required to be construed in harmony with each other.**

- **The words employed in the tax treaties not being those of a regular Parliamentary draughtsman, the words need not examined in precise grammatical sense or in literal sense. Even departure from plain meaning of the language is permissible whenever context so requires, to avoid the absurdities and to interpret the treaty *ut res magis valeat quam pereat* i.e., in such a manner as to make it workable rather than redundant.**

- **A literal or legalistic meaning must be avoided when the basic object of the treaty might be defeated or frustrated insofar as particular items under consideration are concerned. Words are to be understood with reference to the subject-matter, i.e., *verba accopoenda sunt secundum subjectum materiam.***

- **It is inevitable that interpreter of a tax treaty is likely to be required to cope with disorganised composition instead of precision drafting. Therefore, the words employed in the treaty are to be given a general meaning - general to lawyers and general to layman alike.**

- **When a tax treaty does not define a term employed in it, and the context of the treaty so requires, it can be given a meaning different from domestic law meaning thereof. The meaning of the undefined terms in a tax treaty should be determined by reference to all of the relevant information and all on the relevant context. There cannot, however, be any residual presumption in favour of a domestic law meaning of a treaty term.**

(Emphasis supplied by us)

71. Viewed in the light of the detailed analysis above, in our considered view, it is the fact of taxability of entire income of the person in the residence state, rather than the mode of taxability there, which should govern whether or not the source country should extend treaty entitlement with the contracting state in which that person has fiscal domicile. In effect thus, even when a partnership firm is taxable in respect of its profits not in its own right but in the hands of the partners, as long as entire income of the partnership firm is taxed in the residence country, treaty benefits cannot be declined.

72. There is one more way of looking at this issue and one more line of reasoning which leads to the same conclusion.

73. A series of decisions of this Tribunal, beginning with ADIT Vs Green Emirates Shipping & Travels (100 ITD 203), on the issue of entitlement of India UAE tax treaty benefits to UAE resident who are not actually liable to pay any personal income tax, also deal with an important facet of this issue. In these cases, it is held that actual payment of tax in one of the contracting States is not a condition precedent to avail the benefits of DTAA in the other Contracting States because the tax treaty prevents not only 'current' taxation but also ‘potential' double taxation. Once the right to tax UAE residents in specified circumstances vests only with principal State of the UAE under a tax treaty, that right, whether that right exercised or not, continues to remain exclusive right of that state. In the said case, the Tribunal has, inter alia, observed as follows:

> ***"....As noted above, the exemption agreed to under the 'assignment' or ‘distributive' rule, is independent of 'whether the Contracting State imposes a tax in the situation to which exemption implies'. In the case of John N Gladden V Her Majesty***

the Queen 85 TC 5188, which was quoted with approval by the Hon'ble Supreme Court in Azadi Bachao Andolan's case (supra), Federal Court of Canada was observed that''' the non-resident can benefit from the exemption (under the treaty) regardless of whether or not he is taxable on that capital gain in his own country, If Canada or the US were to abolish the capital gains tax completely, while the other country did not, a resident of the country which has abolished the capital gains would still be exempt form capital gains in that country". It is thus clear that taxability in one country is not sine qua non for availing relief under the treaty from taxability in the other courts. All that is necessary for this purpose is that the person should be liable to tax in the contracting State by reason of domicile, residence, place of management, place of incorporation for any other criterion of similar nature which essentially refers to the fiscal domicile of such a person. In other words, if fiscal domicile of a person is that person is actually liable to pay tax in that country, he is to be treated as resident of that contracting State. The expression 'liable to tax" is not to read in isolation but in conjunction with the words immediately following it i.e. 'by reason of domicile, residence, place of management place of incorporation or any other criterion of similar nature'. That would mean that merely a person living in a Contracting State should not be sufficient, that person should also have fiscal domicile in that country. These texts of fiscal domicile which are given by way of examples following the expression 'liable to tax by reason of i.e. domicile, residence, place of management, place of incorporation etc. are no more than examples of locality related attachments which attract, residence type taxation, that 'person' is to be treated as resident and this status of being a 'resident' of the Contracting State is independent of the activity of tax on that person. Viewed in this perspective, we are of the considered opinion that being 'liable to tax in the Contracting State by the virtue of an existing legal provision but would also cover the cases where that other Contracting State has the right to tax such persons irrespective of whether or not such a right is exercised by the Contracting State."

74. The view taken by the Tribunal in the case of Green Emirates Shipping & Travels (supra) of the Tribunal has also been confirmed, a few months later, by a Dutch High Court vide judgment dated 15 February

2006. We consider it appropriate to reproduce the observations made by late Prof Klaus Vogel in the Bulletin for International Taxation (Volume 60 No 6 -2006 at pages 218-219) published by the International Bureau of Fiscal Documentation, Amsterdam. Prof Dr. Klaus Vogel, after referring to the Tribunal decision in the case of Green Emirate Shipping and Travel (supra), had observed as follows:

> ***An unusual case decided by the Dutch Gerechtsh of Amstredam Court of Appeals on 15 February 2006 confirms this decision. The owners of the Dutch company, X BV emigrated from the Netherlands to Greece in 1995 and advised the Dutch tax authorities that they now exercised management and contract fro their new location, as a consequence of which the company became a Greek resident. This was not in dispute in May 2000, the taxpayers informed the Dutch authorities that, sine their relocation, they had endeavoured to register the company with the Greek Tax authorities, but failed to succeed because of the Greek tax authorities, but failed to succeed because of the Greek bureaucracy the company had not yet been assessed to the Greek corporate income tax.***
>
> ***These facts were not contested by the Dutch authorities. But in 2004 they assessed the taxpayers for the Dutch corporate income tax retrospective for the year 1995. The tax inspector argued that, for applying Art 4(1) of the Netherlands-Greece tax liability is not sufficient rather a factual subjective indebtedness" ("een feitelike subjective onderworpnheld") is required. The Court, however, refuted this argument it pointed out that the tax treaty did not postulate factual taxation: instead a legal obligation to pay tax on worldwide income was called for, which under Greek law was established.***

75. A view is thus indeed possible that, given the context in which the expression ‘liable to taxation by reasons of his domicile, residence, place of management or any other criterion of similar nature’ is employed i.e. in the context of ascertaining fiscal domicile – as evident from the title of

Article as 'Fiscal domicile', it is sufficient that under the assignment or distributive rules of the treaty, the residence state has a right to tax income of the partnership firm – irrespective of the fact the position whether or not such a right is actually exercised by the residence state. The undisputed objective of Article 4 is to ascertain fiscal domicile of a person, and the heading of Article 4, as we have reproduced earlier in this order, is "Fiscal domicile". It is a well known Latin legal maxim that ***"A rubro ad nigrum"*** which means, literally, from red to the black. In olden times, the title of a statute as well as headings of a provision in the statute, were written in red while its body text was written in black. This Latin maxim implies that in the process of interpreting a statute, one must start from the title and interpret the text of the provision with reference to its title. The same approach must holds good for interpretation of a tax treaty as well, because that is where contextual interpretation has an even greater role to play. Viewed thus, the purpose of Article 4 is ascertainment of fiscal domicile of a person, and a fiscal domicile is a factual aspect which cannot oscillate due to peripheral variations in the scheme tax laws of that jurisdiction. It is only elementary that no man can be without a domicile. The same is true for an enterprise, and for a fiscal domicile, as well. The test of fiscal domicile is, as adopted in the international taxation, that a person is treated as fiscally domiciled in a tax jurisdiction in which it has a locality related attachment which leads to residence type taxation. The decisive factor of every type of domicile is a locality related attachment, such as a voting right for a person which again is based on where that person ordinarily resides. To ascertain fiscal domicile in the context of taxation, this locality related attachment has to have a further attribute i.e. it should be such as to lead to a full fledged taxation as a person resident in that tax jurisdiction is subjected to. The difficulty, however, arises when a tax jurisdiction does not exercise that right to tax – whether directly in

respect of that category of persons, or even in general terms. It will be somewhat absurd to suggest that, in such situations, that category of persons will not have fiscal domicile anywhere. That is clearly an incongruous result. We must, therefore, apply the test of fiscal domicile in such a manner so as to lead to lead to a reasonable result. In our humble understanding, as long as *de facto* entire income of the enterprise or the person is subjected to tax in that tax jurisdiction, whether directly or indirectly, the taxability test must be held to have been satisfied. Of course, the other possible approach to such a situation is that as long as the tax jurisdiction has the right to tax the entire income of the person resident there, whether or not such a right is exercised, the test of fiscal domicile should be satisfied. Viewed thus, all that matters is whether that tax jurisdiction has a right to tax or not; the actual levy of tax by the tax jurisdiction cannot govern whether a person has fiscal domicile in that jurisdiction or not. Having said that, we are alive to the fact that this line of reasoning is diametrically opposed to the stand taken by the OECD in the matter, but, having carefully considered the stand of the OECD on this issue, we are not persuaded by the OECD stand on the matter, nor the Indian judicial precedents support that position. As a matter of fact, even the Government of India’s approach to the tax treaties does not entirely approve that school of thought either.

76. While on this issue, it is useful to take note of the fact that vide notification No. 282 of 2007, dated 28th November 2007 *(213 CTR Statues 64),* One of the amendments made by the protocol to the India UAE tax treaty is the change in definition of resident in Article 4(1)(b) which now provides that for the purpose of the Indo UAE tax treaty, resident of a Contracting State, in the case of the UAE, means "an individual who is present in the UAE for a period or periods aggregating totalling in aggregate at least 183 days in the calendar year concerned, and a

company, which is incorporated in UAE and which is managed and controlled wholly in UAE". This amendment in the definition of resident of UAE thus accepts the broad proposition that the taxability in one of the Contracting States is not a sine qua non to avail treaty benefits in the other Contracting State. The approach of the learned Departmental Representative to the effect that that a person who is not liable to pay tax under the UK law cannot claim any relief from the tax payable in India under the agreement and that the provisions of tax treaties apply to any cases where the same income is not liable to be taxed twice by the existing laws of both the contracting states is thus no longer backed by the tax administration itself.

77. As we hold that the partnership firm is eligible for treaty benefits in the source country even as it is not taxable in its own right in the residence country, we are alive to the fact that the OECD Report on Partnership does not approve that proposition. As evident from paragraph 40 of the said report – reproduced earlier in the order, even when partnership firm is not taxable in the residence in its own right, the treaty entitlements to the firm are to be denied. However, in the same report, at paragraph 56, the OECD report recommends that, in such a situation, the treaty benefits should accrue to the partners in the partnership firm. However, that is a solution rejected by India, and 2008 update to OECD Model Convention records this reservation as follows:

> ***3. Gabon, India, Ivory Coast, Morocco and Tunisia do not agree with the interpretation put forward in paragraphs 5 and 6 above of the Commentary on Article 1 (and in the case of India, the corresponding interpretation in paragraph 8.7 of the Commentary on Article 4) according to which if a partnership is denied the benefits of a tax convention, its members are entitled to the benefits of the tax conventions entered into by their State***

> ***of residence. They believe that this result is only possible, to a certain extent, if provisions to that effect are included in the convention entered into with the State where the partnership is situated.***

78. In this situation, i.e. when the Government of India has rejected the stand taken in the OECD partnership report and the changes made in the OECD Model Convention Commentary as a result of the same, it cannot be open to hold that in the light of the OECD report, the partnership firm must be declined treaty entitlement benefits. The remedy to unintended consequence of a treaty provision in the said report has been rejected, and, therefore, the treatment accorded to the said provision, in the same report, cannot be accepted either. Any other view of the matter will lead to absurd consequences rather than avoiding the absurd consequences.

79. In view of the above discussions, as also bearing in mind the entirety of the case, we hold that the assessee was indeed eligible to the benefits of India UK tax treaty, as long as entire profits of the partnership firm are taxed in UK – whether in the hands of the partnership firm though the taxable income is determined in relation to the personal characteristics of the partners, or in the hands of the partners directly. To that extent, objection taken by the learned Departmental Representative, on the question of admissibility of India UK tax treaty benefits, is held as maintainable but rejected on merits.

<u>On existence of assessee's permanent establishment in India under Article 5(2)(k)</u>

80. The next issue that we have to decide is whether or not the assessee had a permanent establishment in India.

81. The case of the assessee is that the assessee did not have any permanent establishment in India. The attach against the findings of the authorities below rests on two major planks- first, that since the conditions under Article 5(1) are not fulfilled, there cannot be any question of existence of permanent establishment even under Article 5(2)(k); and – second, that even if Article 5(2)(k) is to be viewed on standalone basis, since there is no 'furnishing' of services by the assessee, and the assessee has merely 'rendered' services, which has connotations materially distinct from that of 'furnishing' services, even the conditions of Article 5(2)(k) are not fulfilled.

82. Learned senior counsel's basic argument is that Article 5(2)(k) of the India UK tax treaty is not to be construed on standalone basis, and it can only be viewed in conjunction with Article 5(1). Learned counsel's case is the sub clauses in Article 5(2) are no more than illustrations of the situations in which Article 5(1) can apply but such examples are to be seen against the background of general definition given in Article 5(1) in such a way that examples listed in Article 5(2) are PE only if they meet the requirements of Article 5(1) of tax treaty. It was thus argued that in order that the assessee can be said to have a PE in India, the basic conditions of Article 5(1) are to be necessarily satisfied, and merely satisfying the requirements of any of the sub clauses in Article 5(2), even if that be so, would not suffice. It was also contended that there was no continuity of activities in India, and the partners and staff members of the assessee firm visited India only on as and when required basis. The activities of the assessee were claimed to be sporadic or isolated. The stand of the assessee thus was that there was no framework or infrastructure, no continuity and no stability so as to result in a permanent establishment. Learned senior counsel has also filed extracts from Prof Klaus Vogel's oft quoted treatise 'Klaus Vogel on Double

Taxation Conventions', and referred to his observations at page 295 to the effect that "[a]rticle 5(2) gives substance to the general permanent establishment concept', that '[w]hat must be particularly examined in each case is whether the place of business satisfies the permanence criterion' and that '[t]he opening sentence of Article 5(2) shows that the list that follows is one of the examples and not exhaustive ('specially')'. Our attention is then invited to paragraph 12 of OECD Model Convention Commentary which, inter alia, observes that, Article 5(2) "contains a list, by no means exhaustive, of examples, each of which can be regarded, prima facie, constituting a permanent establishment" and that "[a]s these examples are to be seen against the background of general definition given in paragraph 1, it is assumed that the contracting states interpret the items listed, 'a place of management', 'a branch', 'an office' etc in such a way that such places constitute permanent establishment only if they meet the requirement of paragraph 1". We are thus urged to interpret Article 5(2) of India UK tax treaty in the light of the above analysis contained in Prof Klaus Vogel's book and OECD Commentary.

83. Learned senior counsel further contends that, in any event, the activities of assessee do not involve furnishing of services as envisaged in Article 5(2)(k) of the Indo UK tax treaty as the assessee is an international professional enterprises rendering services directly to its clients. We are taken through dictionary meanings of expressions 'furnishing' and 'rendering' and efforts are made to demonstrate that these expressions cannot be used interchangeably, since these expressions have significantly different connotations. Learned counsel further submits that the professional services, like that of the lawyers, are dealt with Article 15 of India UK tax treaty. He, however, hastens to add that Article 15 cannot be invoked on the facts of this case anyway, since this provision can only be invoked when professional services are

rendered by individuals. It is submitted that the wordings of Article 15 are clear, unambiguous and incapable of any other interpretation. He thus submits that the Assessing Officer is in error in giving a 'without prejudice' finding to the effect that, even if provisions of Article 5(2)(k) are held to be inapplicable, the assessee will still have taxability in India in terms of the provisions of Article 15. Learned counsel concludes by submitting that since the provisions of Article 5 or Article 15 donot apply to the situation before us, and since income of the assessee is not taxable in India under any other provisions of the India UK tax treaty either, the income of the assessee, in terms of the provisions of India UK tax treaty, is not taxable in India at all.

84. Learned Commissioner – Departmental Representative, on the other hand, contends that Article 5(2)(k) is a deeming fiction and it has to be, therefore, construed on standalone basis, in the sense once the conditions laid down in Article 5(2)(k) are satisfied, nothing further is needed to hold that permanent establishment exists. Learned Commissioner contends that the provisions of Article 5(2) and Article 5(1) are not be read together, nor does Article 5(1) restrict the application of Article 5(2). In case, one is to proceed on the basis that a permanent establishment under Article 5(2) (k) can come into existence only when conditions of Article 5(1) are also to be satisfied, Article 5(2)(k) will be rendered redundant. Under Article 5(2)(k), if services to an associated enterprise are rendered even for 30 days, it will result in existence of the deemed PE. However, Article 5(1) can come into play only when the assessee has a fixed place of business but once assessee has a fixed place of business, it is wholly irrelevant whether or not services are rendered for one day or for all the three hundred and sixty five days. It is thus submitted that in the case of Article 5(2)(k), permanence test of the PE has been substituted by the duration test for

services rendered. Once the duration test is satisfied, according to the learned Commissioner, permanence test visualized in Article 5(1) does not come into play at all. We are thus urged to hold that Section 5(2)(k) is to be decided on standalone basis, and that as long as conditions set out in Article 5(2)(k) are satisfied and, irrespective of fulfilment or non fulfilment of conditions under Article 5(1), permanent establishment comes into existence. As regards the connotations of expressions 'furnishing' and 'rendering', it is submitted that distinction sought to be made out is without any material difference. The difference between 'furnishing of services' and 'rendering of services', even if any, does not have any effect on the question as to whether there is any permanent establishment. We are thus urged to confirm the findings of the authorities below and decline to interfere in the matter.

85. In rejoinder, learned counsel for the assessee reiterates his submissions on the same line. He submits that Article 5(2)(k) is more of an elaboration on the scope of and restriction on the applicability of Article 5(1), rather than an extension of Article 5(2)(k). He submits that Article 5(2)(k) will not be rendered infructuous in case we are to proceed on the basis that satisfaction of conditions of Article 5(1) is a *sine qua non* for holding existence of PE, because, in any event, Article 5(2)(k) is no more than an example or illustration of a PE. He once again highlighted the difference between rendering of and furnishing of services and submitted that these differences can not be simply wished away or held to be of no consequence. On the basis of all these arguments, and relying upon the stand taken by the assessee before the authorities below, he once again urges us to hold that the assessee did not have any permanent establishment in India, and since the assessee did not have any permanent establishment in India, no part of its business income can be taxed in India.

86. We have given our careful consideration to the rival submissions, perused the material on record and duly considered the applicable legal position.

87. We consider it appropriate to reproduce below the provision contained in Article 5 of India UK tax treaty, which is subject matter of our consideration:

> ***Article 5 - Permanent establishment***
>
> ***(1) For the purposes of this Convention, 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;***
>
> ***(f) premises used as a sales outlet or for receiving or soliciting orders;***
>
> ***(g) a warehouse in relation to a person providing storage facilities for others;***
>
> ***(h) a mine, an oil or gas well, quarry or other place of extraction of natural resources;***
>
> ***(i) an installation or structure used for the exploration or exploitation of natural resources;***
>
> ***(j) a building site or construction, installation or assembly project or supervisory activities in connection therewith, where***

such site, project or supervisory activity continues for a period of more than six months, or where such project or supervisory activity, being incidental to the sale of machinery or equipment, continues for a period not exceeding six months and the charges payable for the project or supervisory activity exceed 10 per cent of the sale price of the machinery and equipment;

(k) the furnishing of services including managerial services, other than those taxable under Article 13 (Royalties and fees for technical services), within Contracting State by an enterprise through employees or other personnel, but only if:

> ***(i) activities of that nature continue within that State for a period or periods aggregating more than 90 days within any twelve-month period; or***
>
> ***(ii) services are performed within that State for an enterprise within the meaning of paragraph (1) of Article 10 (Associated enterprises) and continue for a period or periods aggregating more than 30 days within any twelve- month period.***

Provided that for the purposes of this paragraph an enterprise shall be deemed to have a permanent establishment in a Contracting State and to carry on business through that permanent establishment if it provides services or facilities in connection with, or
supplies plant and machinery on hire used or to be used in, the prospecting for, or extraction or production of, mineral oils in that State.

(3) The term "permanent establishment" shall not be deemed to include:

(a) the use of facilities solely for the purpose of storage or display of goods or merchandise belonging to the enterprise;

(b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage or display;

(c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

(d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or for collecting information, for the enterprise;

(e) the maintenance of a fixed place of business solely for the purpose of advertising, for the supply of information or for scientific research, being activities solely of a preparatory or auxiliary character in the trade or business of the enterprise. However, this provision shall not be applicable where the enterprise maintains any other fixed place of business in the other Contracting State for any purpose or purposes other than the purposes specified in this paragraph;

(f) the maintenance of a fixed place of business solely for any combination of activities mentioned in sub-paragraphs (a) to (e) of this paragraph, provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

(4) A person acting in a Contracting State for or on behalf of an enterprise of the other Contracting State—other than an agent of an independent status to whom paragraph (5) of this Article applies—shall be deemed to be a permanent establishment of that enterprise in the first-mentioned State if:

(a) he has, and habitually exercises in that State, an authority to negotiate and enter into contracts for or on behalf of the enterprise, unless his activities are limited to the purchase of goods or merchandise for the enterprise; or

(b) he habitually maintains in the first-mentioned Contracting State a stock of goods or merchandise from which he regularly delivers goods or merchandise for or on behalf of the enterprise; or

(c) he habitually secures orders in the first-mentioned State, wholly or almost wholly for the enterprise itself or for the enterprise and other enterprises controlling, controlled by, or subject to the same common control, as that enterprise.

(5) An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other State through

a broker, general commission agent or any other agent of an independent status, where such persons are acting in the ordinary course of their business. However, if the activities of such an agent are carried out wholly or almost wholly for the enterprise (or for the enterprise and other enterprises which are controlled by it or have a controlling interest in it or are subject to the same common control) he shall not be considered to be an agent of an independent status for the purposes of this paragraph.

(6) The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

(7) For the purposes of this Article the term "control", in relation to a company means the ability to exercise control over the company's affairs by means of the direct or indirect holding of the greater part of the issued share capital or voting power in the company.

88. Article 5(1) of the India UK tax treaty refers to the requirements of, what is often termed as, basic rule PE. This refers to a fixed place of business through which business of the enterprise is wholly or partly carried out. Elaborating upon the scope of this provision, a co ordinate bench of this Tribunal, in the case of Airline Rotables Ltd UK Vs Joint Director of Income Tax (40 DTR 226) and after analysis of earlier decisions of this Tribunal in the cases of Western Union Financial Services Inc Vs ADIT (104 ITD 34) and Motorola Inc Vs DCIT (95 ITD 269 SB), has observed that, " There are three criterions embedded in this definition – physical criterion i.e. existence of physical location, subjective criterion i.e. right to use that place, functionality criterion i.e. carrying out of business though that place. It is only when these three conditions are satisfied, a PE under the basic rule can be said to have come into existence."

89. Article 5(2), however, consists of two heterogeneous categories of permanent establishments. The first category consists of illustrations of what would constitute a PE, even under the basic rule, and the second category consists of, what can be termed as, extensions of the basic rule and deemed permanent establishments. While clauses (a) to (i) of Article 5(2), in our humble understanding, form part of the former category i.e. illustrative of the basic rule, clauses (j) and (k), as we understand, form part of the second category i.e. extensions of the basic rule. The descriptions in these two categories are listed under separate sub articles in OECD Model Conventions, UN Model Convention and even under US Model Conventions. The very fact that these two categories have been segregated in these model conventions also shows that these two categories belong to different genus. To appreciate this point, it may be useful to take a look at the relevant clauses of OECD, UN and US Model Conventions, which are reproduced below:

> ***<u>UN Model Convention</u>***
> ***Article 5 - PERMANENT ESTABLISHMENT***
>
> ***1. For the purposes of this Convention, 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" includes especially:***
>
> ***(a) A place of management;***
> ***(b) A branch;***
> ***(c) An office;***
> ***(d) A factory;***
> ***(e) A workshop;***
> ***(f) A mine, an oil or gas well, a quarry or any other place of extraction of natural resources.***
>
> ***3. The term "permanent establishment" also encompasses:***

(a) A building site, a construction, assembly or installation project or supervisory activities in connection therewith, but only if such site, project or activities last more than six months;

(b) The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than six months within any twelve-month period.

__OECD Model Convention__
Article 5 - PERMANENT ESTABLISHMENT

1. For the purposes of this Convention, 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" includes especially:
a) a place of management;
b) a branch;
c) an office;
d) a factory;
e) a workshop, and
f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

3. A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.

__US Model Convention__
Article – 5 PERMANENT ESTABLISHMENT

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f) a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources.

3. A building site or construction or installation project, or an installation or drilling rig or ship used for the exploration of natural resources, constitutes a permanent establishment only if it lasts, or the exploration activity continues for more than twelve months.

90. A plain reading of Article 5(2) of India UK tax treaty, in the light of the above discussions, clearly shows Article 5(2) of India UK tax treaty is a mixture of what is usually contained in Article 5(2) and Article 5(3) in all major model conventions i.e. UN Model Convention, OECD Model Convention an UN Model Convention. The clauses consisting in Article 5(2) of India UK tax treaty are, therefore, not homogenous and these clauses do not belong to the same genus. One cannot therefore proceed on the basis, as has been urged by the learned senior counsel for the assessee, that some degree of uniformity in treatment of all these sub clauses is warranted. What applies to clause (a) to (i) of this Article does not necessarily also apply to article (j) and (k) of this Article 5. As regards the first category of permanent establishments, i.e. under clause (a) to (i), OECD Model Convention Commentary, which is also adopted by the UN Model Convention Commentary, does state that the second paragraph of model conventions, " it contains a list, by no means exhaustive, of examples, each of which can be regarded, prima facie,

constituting a permanent establishment", and that "as these examples are to be seen against the background of general definition given in paragraph 1, it is assumed that the contracting states interpret the items listed, 'a place of management', 'a branch', 'an office' etc in such a way that such places constitute permanent establishment only if they meet the requirement of paragraph 1". Even by the OECD Model Convention Commentaries, however, this theory is not extended to the items in second category i.e. (j) and (k). So far as paragraph 3 of the OECD Model Conventions dealing with these items are concerned, OCED Model Convention Commentary states as follows:

> ***" This paragraph <u>provides expressly</u> that a building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months. <u>Any of those items which does not meet this condition does not of itself constitute a permanent establishment, even if there is within it an installation, for instance an office or a workshop within the meaning of paragraph 2, associated with the construction activity.</u> Where, however, such an office or workshop is used for a number of construction projects and the activities performed therein go beyond those mentioned in paragraph, it will be considered a permanent establishment if the conditions of the Article are otherwise met even if one of the projects involved…….lasts for more than 12 months***"

(Emphasis supplied by us)

91. It is thus clear that, even as per the OECD Model Convention, one of the items included in Article 5(2), i.e. 5(2)(j), of India UK tax treaty is such that it would not constitute permanent establishment under the basic rule of Article 5(1), and it is only on account of deeming fiction provided by the provision of Article 5(2)(j), it can be treated as a permanent establishment. We are in considered agreement with this analysis in OECD Model Convention Commentary, and, for this reason, we

are unable to approve learned counsel's argument that Article 5(2) of India UK tax treaty only provides examples of situations covered by Article 5 (1).

92. UN Model Convention Commentary, dealing with Article 5(3) which is in *pari materia* with Article 5(2)(j) and (k) of India UK tax treaty, makes the position even more clear by observing, inter alia, as follows:

> ***Article 5, paragraph 3, subparagraph (b), <u>deals with the furnishing of services</u>, including consultancy services, <u>which are not covered specifically in the OECD Model Convention in connection with the concept of permanent establishment</u>.***
>
> (Emphasis supplied by us)

93. According to this analysis in the UN Model Convention Commentary, and with which we are in considered agreement, Article 5(3)(b) of UN Model Convention, which is materially similar to the provisions of Article 5(2)(k) of India UK tax treaty, extends to the areas not covered by the OECD Model Convention. Obviously, a permanent establishment under basic rule cannot be said to be not covered by the OECD Model Convention. According to the UN Model Convention Commentary, the scope of this provision extends beyond the scope of permanent establishment under the basic rule. For this reason also, we are unable to accept learned counsel's suggestion that Article 5(2) of India UK tax treaty should only be read as a bunch of illustration of permanent establishments under the basis rule set out in Article 5(1).

94. Learned senior counsel is perhaps quite right to the extent that Article 5(2), as in most standard model conventions, is no more than an illustration or examples of application of permanent establishment under

basic rule i.e. under Article 5(1). However, so far as the provisions of India UK tax treaty are concerned, for the detailed reasons set out above, these arguments do not hold good in respect of clause (j) and (k) of Article 5(2), which are on the lines of provisions in Article 5(3) in all most standard model conventions. For this reason, we also reject learned counsel's reliance on the OECD Model Convention Commentary and Prof Klaus Vogel's analysis. His reliance on these commentaries are misplaced as the provisions these commentaries have dealt with are not in *pari materia* with the tax treaty provisions that we are *in seisin* of.

95. We may also add that similar argument, materially similar to the argument raised by the assessee before us and in respect of materially similar treaty provision, also came up for consideration before Hon'ble Authority for Advance Ruling in the case of XYZ In Re (242 ITR 208). Rejecting this plea, Hon'ble Justice Ranganathan, Chairman - AAR, observed as follows:

> **23. The learned counsel also submitted that the definition of PE is only what is formulated in Article 5(1) and that Article 5(2) is only illustrative of the cases that fulfill the requirement of paragraph 1 of Article 5. In other words, XYZ cannot be said to have a PE even if the requirements of sub clause (1) are satisfied, unless it has a fixed place of business in India. He relies on paragraph 11 of the Commentary on OECD Model Convention which reads thus :**
>
> > **11.[General Remarks] This paragraph contains a list, by no means exhaustive, of examples, each of which can be regarded, prima facie, constituting a permanent establishment. As these examples are to be seen against the background of general definition given in paragraph 1, it is assumed that the contracting states interpret the items listed, 'a place of management', 'a branch', 'an office' etc in such a way that such places constitute permanent establishment only if they meet the requirement of paragraph 1.**

> **This argument may run contrary to the well established principle of statutory interpretation that an inclusive definition is intended to add to primary meaning so as to bring within its scope items which may or may not fall within the scope of the primary definition. That apart, even assuming, at best, that the inclusion clause is to be interpreted 'against the background' of the general definition contained in paragraph 1 and bear some analogy to it, all that can be said is that sporadic and isolated activities, referred to in clause (1), will not be sufficient to constitute PE and that there should be some degree of 'continuity' or 'durability' and a framework against which the services are rendered. That kind of framework and degree of stability is present here. It must, therefore, be held that XYZ has a PE in India.**
>
> (Emphasis supplied by us)

96. We are in considered and respectful agreement with the legal proposition so laid down by the Hon'ble Authority for Advance Ruling. Interestingly, in this case, even as it was not brought to the notice of the Hon'ble Authority of Advance Ruling that the OECD Commentary is in respect of the provisions which are not in *pari materia* with the respective tax treaty provisions [the provisions of Article 5(2) of OECD Model Convention, in respect of which commentary was written and as we have seen earlier in this order, are materially distinct from the tax treaty provisions of Article 5(2) which came up for consideration before the AAR and before us], Hon'ble Authority for Advance Ruling reached the same conclusions. On the basis of the line of reasoning adopted by the AAR also, we reject the contention of the assessee.

97. Let us once again take a look at Article 5(2)(k) and further analyze its scope and purpose. It provides that the term 'permanent establishment' shall include specially the furnishing of services including managerial services within Contracting State by an enterprise through employees or other personnel, where such activities are rendered for

more than 90 days for any enterprises, or for more than 30 days for an associated enterprise, within any twelve month period. The only exclusion clause envisaged from the services so furnished is when the consideration for such services is taxable in the source jurisdiction under Article 13. In order to invoke this provision, all that is needed is that

(a) a resident of other contracting state furnishes services

- for more than 90 days, within any twelve month period, for any enterprises [excluding an associated enterprises within the meanings of that expression under Article 10(1)], **or**

- for more than 30 days, within any twelve month period, for an associated enterprises within the meanings of that expression under Article 10(1);

(b) consideration for services so furnished are not taxable in the source jurisdiction under Article 13 of the India UK tax treaty.

98. There is no dispute about the fact that the assessee has fulfilled the 90 days duration test, envisaged in Article 5(2)(k) analyzed above, and the fact that consideration for services rendered by the assessee are not taxable in India under Article 13 of the India UK tax treaty.

99. The unresolved dispute on the question of existence of permanent establishment thus narrows down to the connotations of ‘furnishing of services’, which, according to the learned counsel, can not be so construed as to cover ‘rendering of services’ by such professionals as lawyers.

100. Learned senior counsel has mainly invited our attention to the dictionary meanings of the expression 'furnish', and pointed out that one of these meanings, as per Oxford English Dictionary and on which learned counsel has laid great emphasis, is "to provide or supply with". It is primarily on this basis that it is contended that expression 'furnishing' refers to providing for or arranging or supplying the services, rather than rendering the services oneself as is done by the professionals like lawyers.

101. We are, however, unable to see legally sustainable merits in this plea. As for the hyper technical suggestion that professional services can only be 'rendered' and not 'furnished', and the connotations of furnishing of services cannot be extended to rendering of services, we may mention that connotation of 'rendering' also extend to "to give or make available; provide" (www. thefreedictionary. com/ render) and " to furnish; to state; to deliver; as to render an account; to render judgment (http://www. webster-dictionary.org/definition/render). Similarly, one of the usage of expression 'furnish' also refers to 'to furnish one with knowledge or principles" (www.webster-dictionary.org /definition/ furnish). The expression 'rendering' and 'furnishing' are somewhat interchangeable in normal course of business, and it will be too pedantic and hyper technical an approach to narrow down the meaning of the expression 'furnishing' to exclude rendering of professional services. A treaty, as we have see in detailed analysis of principles of interpretation of tax treaties earlier in this order, is to be interpreted in good faith on the basis of general expectations of the parties and in accordance with the ordinary meaning given to the treaty in the context and in the light of its objects and purpose. The interpretation canvassed by the learned counsel does not fit into this approach to treaty interpretation.

102. In any event, one cannot interpret a tax treaty, or for that purpose even a tax legislation, with dictionary in one hand and tax treaty in another. As Justice Hand has observed in the context of interpreting tax law, which is even more relevant in the context of interpreting a tax treaty, "it is one of the surest indexes of a mature and developed jurisprudence not to make a fortress out of the dictionary but to remember that statutes always have some purpose or object to accomplish, whose sympathetic and imaginative discovery is the surest guide to their meaning". And object and purpose of Article 5(2)(k) is unambiguously set out in UN Model Convention Commentary which, dealing with Article 5(3)(b), which is in *pari materia* with Article 5(2)(k) of India UK tax treaty, states that, "[i]t is believed that management and consultancy services should be covered because the provision of such services in developing countries by corporations of industrialized countries often involves very large sums of money". This objective, by no stretch of logic, supports the interpretation canvassed by the learned counsel.

103. Learned counsel has also contended that the rendition of professional services cannot be covered by a permanent establishment under Article 5, as Article 5 refers to commercial and industrial establishments. It is, interesting, however to note that Article 14 (corresponding to Article 15 of India UK tax treaty) of the OECD Model Convention, which deals with the taxability of professional services in the source country, was deleted from the OECD Model Convention on the ground that 'there is no intended difference between the concepts of permanent establishment, as used in Article 7, and fixed base, as used in Article 14…'. It is thus clear that professional services are also covered by

Article 5, as evident from the following observation in OECD Model Convention Commentary:

> **[Commentary on Article 14 concerning the taxation of independent personal services]**
>
> **[Article 14 was deleted from the Model Tax Convention on 29 April 2000 on the basis of report entitled 'Issues Related to Article 14 of the OECD Model Convention (adopted by the Committee on Fiscal Affairs on 27 January 2000 and reproduced in Volume II at page R (16)-1). That decision reflected that there was no intended difference between the concepts of permanent establishment, as used in Article 7, and fixed base, as used in Article 14, or between how profits are computed and tax was calculated according to which of Article 7 or 14 applied. In addition, it was not always clear which activities fell within Article 14 as opposed to Article 7. The effect of the deletion of Article 14 is that income derived from professional services or other activities of independent character is now dealt with under Article 7 as business profits.]**

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Indian reprint at page 204)

104. The above analysis shows that professional services are not beyond the scope of Article 5, existence of which is sine qua non for any taxability under Article 7. We agree with this analysis. In this view of the matter, we reject the contention that professional services cannot be covered by the provisions of Article 5(2)(k).

105. Learned counsel has also contended that the professional services can only be taxed under the head Article 15 and in case

chargeability under Article 15 fails, that is end of the road. It cannot be open to revenue authorities to tax income from professional services under Article 7. It is contended that Article 15 applies only to individuals. As to the situations in which Article 5 will apply in respect of the professional services and the situations in which Article 15 of the India UK tax treaty, which is in *pari materia* Article 14 of the UN Model Convention, will apply, we find guidance from the following observations made in the UN Model Convention Commentary:

> ***The Group discussed the relationship between article 14 and subparagraph 3(b) of article 5. It was generally agreed that remuneration paid directly to an individual for his performance of activity in an independent capacity was subject to the provisions of article 14.Payments to an enterprise in respect of the furnishing by that enterprise of the activities of employees or other personnel are subject to articles 5 and 7. The remuneration paid by the enterprise to the individual who performed the activities is subject either to article 14 (if he is an independent contractor engaged by the enterprise to perform the activities) or article 15 (if he is an employee of the enterprise). If the parties believe that further clarification of the relationship between article 14 and articles 5 and 7 is needed, they may make such clarification in the course of negotiations.***

106. We are in considered agreement with this analysis in the UN Model Convention Commentary. We are thus of the considered view that, in a situation like the one that we are *in seisin* of, i.e. in which specific provisions for professional services or independent personal services or included services exist under Article 15, when services are rendered by the enterprise, Article 5(2)(k) will come into play, and when services are rendered by an individual, Article 15 will find application. Therefore, while we agree with the learned counsel that Article 15 will not be

applicable on the facts of the present case, this finding does not really come to the rescue of the assessee since, as we have already held, the assessee did have a PE in India under Article 5(2)(k) of the India UK tax treaty, and, accordingly, profits attributable to the PE are taxable under Article 7 of the India UK tax treaty.

107. In view of the above discussions, we are unable to uphold the plea so strenuously argued by the learned counsel for the assessee, and we hold that the authorities below have rightly invoked the provisions of Article 5(2) (k). We approve the same, and decline to interfere in the matter.

On adjustments required claimed by the assessee in earnings of the permanent establishment, on the basis of prevailing market prices of similar services, in view of independence fiction of Article 7 (2)

108. Learned counsel has raised an interesting point about the impact of PE's hypothetical independence on profit attribution to PEs. He takes us through the text of Article 7(2) of India UK tax treaty and emphasizes that the profits of the PE are deemed to the he profits which "that permanent establishment might be expected to make if it were a 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". It is thus pointed out that the profits attributable to PE are not the actual profits of the PE but hypothetical profits which the PE was expected to make if the PE was wholly independent of the general enterprise of which it is PE. According to the learned counsel, this exercise of computing hypothetical

profits also warrants adjustments in the bills raised by the GE, in respect of the work carried out by the PE, as the prevalent market prices of similar services as were rendered by the PE were lower than the rates charged by the GE to its clients. It is thus contended that for the purpose of computing income of the PE, the value of services rendered by the PE is to taken at the market value of such services in India and not the price at which GE has billed the clients. On this basis, he contends that as against the actual billing by the GE to the clients, the revenues of the PE should be taken at the rate of UK Pounds 100 per hour for the partners. And UK Pounds 75 for assistants, which at best is the market price of such services rendered in India. According to the learned counsel, when profits attributable to PE in India are to computed, one has to take into account the revenue that the PE in India would have earned, for rendering these services, at the prevalent market rates in India.

109. Learned Commissioner (Departmental Representative) does not share that perception, and submits that learned counsel's interpretation of Article 7(2) is stretching the fiction of hypothetical independence to absurd lengths. He submits that all that Article 7(2) requires is that the income and expenditure of an enterprises as a whole are to be allocated to the permanent establishment, to the extent the same are relatable to the permanent establishment, and the transactions between the enterprise and PE are to be taken into account for computing the PE profits. Article 7(2) does not visualize revenue billings relatable to the PE to be substituted by the market value of such services. It is contended that such an exercise will be a such highly subjective exercise which is inherently being capable to be put to practice and it will render the computation formula of PE profits wholly unworkable. Learned Commissioner submits that in case incomes of the PE are to be adjusted

for the market rate in the open market, even the expenditure of the PE are to be adjusted on the same basis. In such a situation, it will not be an allocation of profits to the permanent establishment but to construct the imaginary profits which the assessee would have earned if it was to render services in India on the rates prevalent in India. It is only elementary that what is to be charged to tax is real income and not a notional income which the assessee could have earned under an imaginary state of affairs. He also contends that when revenue generated by the permanent establishment is to be substituted by the likely revenues generated, in the fictional independence of PE, at the local prevalent rates, and expenditure of the permanent establishment is taken at the actual figure, which is obviously much higher than domestic costs in India, it will clearly present a highly distorted, and somewhat absurd, figure of income. We are urged to avoid this patent absurdity of results, and hold that the actual billing figures are taken in computation of income of the assessee's PE in India.

110. In rejoinder, learned counsel for the assessee once again invited our attention to the wordings of Section 7(2) and reiterated his submissions. It was submitted that there will not be absurdity of results, and, on the contrary, such adjustments carried out to the revenue figures will lead to true hypothetical profits being brought to tax, as indeed visualized by the scheme of things envisaged in Article 7(2) of the India UK tax treaty. Learned counsel urges us to respect and give a sensible meaning to the scheme of taxability of PE profits under Article 7(2) of the India UK tax treaty. He also points out that there is no other way, except by carrying out the adjustments that the assessee has claimed, in which clear words of Article 7 (2) can be given effect. One cannot proceed in a manner , contends the learned counsel, so as to ignore the words

"profits which it might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly at arm's length". It is submitted that not carrying out the adjustments in respect of market price will have the effect of these words being ignored for all practical purposes.

111. We have heard the rival submissions, perused the material on record and duly considered the factual matrix of the case as also the applicable legal position. In order to adjudicate on the above controversy, what we really need to decide is the manner and extent to which theory of hypothetical independence enshrined in Article 7(2) is to be applied in computation of the profits attributable to PEs.

112. We may first reproduce Article 7 of the India UK tax treaty, which deals with and lays down mechanism of computing profits of the permanent establishment. This article is as follows:

> ***ARTICLE 7 - Business Profits***
>
> ***1. The profits of an enterprise of a contracting state shall be taxable in that State unless the enterprise carried on business in the other contracting state through 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 directly or indirectly attributable to that permanent establishment.***
>
> ***2. Where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, the profits which that permanent establishment might be expected to make, if it***

> ***were a distinct and separate enterprise engaged in the same or similar activities in same or similar conditions and dealing wholly independent with the enterprise of which it is permanent establishment, shall be treated for the purposes of paragraph 1 of this Article as profits directly attributable to the permanent establishment.***
>
> ***[Article 5(3) to 5 (7) are not reproduced as these are not relevant for the present purposes]***

(Emphasis supplied by us)

113. In terms of the provisions of Article 7(2), the profits of the PE which are to be taxed in the source country are which the PE might be expected to make "***if it were a distinct and separate enterprise engaged in the same or similar activities in same or similar conditions and dealing wholly independent with the enterprise of which it is permanent establishment***". Explaining the import of this provision, OECD Model Convention Commentary states as follows:

> ***This paragraph contains the central directive on which the allocation of profits to the permanent establishment is based. The paragraph incorporates the view, which is generally contained in bilateral conventions, that the profits to be attributed to a permanent establishment are those which the permanent establishment would have made if, instead of dealing with the head office, it had been dealing with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market…………………The arm's length principle also extends to the allocation of profits which the permanent establishment may derive from transactions with other permanent establishments of the enterprise……***

114. We are in considered agreement with the above analysis. In our considered view, the fiction of hypothetical independence indeed provides mechanism for taking into account intra organization transactions whether these are GE-PE transactions or PE-PE transactions,

and it also extends, in whatever limited way, to ensuring that the transaction value between permanent establishments and the general enterprises, to which it belongs, as also with the inter se transactions between permanent establishments of the same general enterprises are reflected at arms length price.

115. In computation of PE profits, recognition of GE PE transactions, as also recognition of transactions between PEs *inter se* (of PEs belonging to a common general enterprises), at arms length price, has dual role to perform. In the first place, the very recognition of these transactions ensures that intra GE transactions are duly taken into account so as to separately ascertain profits subject to tax in each tax jurisdiction. Secondly, inclusion of arms length principle in the recognition of these transactions ensures that the allocation of profits in a cross border economic activity is not distorted by way of manipulation of transaction values between the associated enterprises.

116. It is important to bear in mind that a school of thought does exist to the effect that but for this fiction of hypothetical independence, intra organization transactions cannot be taken into account while computing the profits of the PE. The reasoning in support of this proposition is this. As is the elementary legal position, nobody can make profits or losses out of transactions with himself, and intra organization transactions can indeed be viewed as transactions with oneself because a PE is nothing but a part of the enterprise itself. It is also important to bear in mind the fact that in the case of business activity involving more than one tax jurisdiction, computation of profits of PEs is only an act of allocation of overall profits to various tax jurisdictions in such a manner that sum of PE profits in all jurisdictions is equal to the overall profits of the GE.

117. Let us take a look at functioning of this principle with the help of an illustration. Take for example, an enterprise based in 'X' tax jurisdiction, which has PEs in 'A', 'B' and 'C' jurisdictions. This GE buys raw diamonds from A jurisdiction, gets them polished in B jurisdiction and sells them through a sales outlet in C jurisdiction, while entire general coordination as also sales and marketing activity is centralized in X jurisdiction itself. Let us further assume that average cost of raw diamond per unit is Rs 1 million, its processing cost per unit billed by PE in B jurisdiction is Rs 0.5 million, and its other costs in connection with coordination and sales and marketing billed from X jurisdiction work out to Rs 0.1 million per unit. In case the average sale price per unit of diamond is Rs 2 million, in this situation, the overall profits of enterprises will be Rs 4,00,000 per unit. To this extent, there cannot be any disputes. However, so as taxation in C jurisdiction is concerned, it will depend on whether or not the intra organization transactions are recognized for tax purposes, and, if so, at what price. In case, C jurisdiction holds that the payment of processing charges that the C PE has made to another PE, i.e. in B jurisdiction, cannot be allowed as a deduction, as it is a payment from one arm of the business to another arm of the same business (i.e. from self to self), the taxable profits in C will go up by that extent. In case, tax authorities also decide that, in any case, deduction can not be allowed in respect of centralized coordination, sales and marketing, because these payments are only payments by self to self, the profit in C jurisdiction end up being only the difference between sales price and cost of raw diamonds. The profits so arrived at will clearly be more than overall profits of the enterprise. The proposition that intra organization transactions cannot be taken into account has been subject matter of litigation in India as well. One could possibly argue that, in view of Hon'ble Calcutta High Court judgment in the case of Betts Hartley

Huett & Co Ltd Vs CIT (116 ITR 425) , transactions between head office and branch office (GE and PE, in treaty terms) are to be ignored for the purposes of computing PE profits. Applying this principle, in the given example, while overall profit on sale of each unit of diamond will be Rs 4,00,000 but it will end up paying profits on sale of diamond at the rate of Rs 10,00,000 per unit in the C tax jurisdiction in which sales outlet is situated. The jurisdictional profits of the PE will thus end up being much more than overall profits of the GE itself – obviously an unintended and absurd result. However, this incongruity is removed when we apply the principle embedded in Article 7(2), as it mandates intra organization transactions being taken into account for computation of PE profits. Going by the principle set out in Article 7(2), these transactions, whether otherwise leading to a permissible deduction under the domestic law or not, are duly taken into account in computation of PE profits, which, in turn, helps ascertainment of taxable profits in each of the tax jurisdiction involved in a case where more than one tax jurisdictions are involved in a business activity. This is first role that the scheme of Article 7(2) plays.

118. The other role played by the fiction of Article 7(2) is that the transaction values in case of such intra organization transactions is taken at an arms length price, so as to neutralize any undesirable impact of collusive undervaluation or overvaluation of such transactions. Lets not forget that when the fictional independence in PE profit attribution clause was introduced, the transfer pricing legislation was nowhere in sight globally. In our considered view, the effect of this arms length requirement in the scheme of Article 7(2) is that when a tax authority can demonstrate that the transaction values in case of related transactions are not at an arms length price, to the extent the transaction values vary from arms length price, the same can be ignored.

119. Using the figures in the illustration that we can taken a little earlier, let us assume that instead of billing the PE in C tax jurisdiction for processing of diamond @ Rs 0.5 million per unit, which is fair market value of this processing in B jurisdiction, the PE in B jurisdiction raises bills of processing charges @ Rs 0.9 million per unit, entire profits of C jurisdiction will shift from C jurisdiction to B jurisdiction. In this case, while sum of taxable profits in different tax jurisdictions will not exceed overall profits of the enterprise, the allocation of such profits will be distorted. It is in this way, that the adjustments for arms length price under the scheme of Article 7(2) seeks to prevent such distortions in allocation of taxable profits in various tax jurisdictions involved in a business activity involving several tax jurisdiction.

120. As noted by Raffaele Russo, in his article 'Application of Arms length Principle to Intra Company Dealings : Back to Origins (2005 ITPJ 7; published by IBFD, Amsterdam), the genesis of arm's length as an international agreed principle goes back to 1933, when the Fiscal Affairs Committee of the League of Nations approved a "Draft Convention on the Allocation of Business Profits Between States for the Purposes of Taxation". The 1933 Draft Convention is based on the principle that permanent establishments ('PEs') must be treated in the same manner as independent enterprises operating under the same or similar conditions. According to this report, the above principle leads to the corollary that the taxable income of a PE must be determined on the basis of its separate accounts. That is how arms length principle saw the light in the field of intra-company dealings, which was later extended to transactions between associated enterprises, which are separate legal entities.

121. Whether it was in respect to the GE- PE transactions, or *inter se* transactions with PEs belonging to the same GE, the underlying thrust of the adjustments envisaged under Article 7(2) is that any distortions in assigned transaction values, which are obviously determined by the GE itself, are neutralized by the appropriate arms length price adjustments, if need be. It is also important to bear in mind the fact that at the time of this arms length principle being introduced in computation of PE profits, the transfer pricing law did not exist. In fact it was almost after three decades of this principle being introduced in the tax treaties that first piece of transfer pricing legislation in the world came into existence in the United States, and well after seven decades of the same, that transfer pricing legislation saw light of the day in India. There is, thus, certain degree of overlapping in the scope of adjustments contemplated by Article 7(2) vis-à-vis arms length adjustments under transfer pricing law, and, in any event, both of these adjustments belong to the same genus and are for the same purposes.

122. Quite clearly, therefore, the arms length price as embedded in scheme of computation of PE profits in tax treaties, was precursor to the transfer pricing legislation. It is in this backdrop that one needs to understand the scheme of Article 7(2).

123. Elaborating upon the scope of Article 7(2), Prof Klaus Vogel, in his book 'Klaus Vogel on Double Taxation Conventions' at page 432, observes as follows:

> ***The idea of arms length test as a criterion for determining the profits of permanent establishment can be traced back to the studies made, at the League of Nation's request, in 1932/33 by Mitchell B Carroll and Ralph C Jones. In their studies, Carroll and Jones unanimously concluded that permanent establishment of international enterprises should, as far as possible, be treated independent units and, consequently, goods supplied by the a permanent establishment to its head office and vice versa should be taken to have been charged at the market prices.***

124. It is thus clear that the fiction of hypothetical independence is confined to a permanent establishment's transactions with its general enterprises, i.e. enterprises of which it is permanent establishment, other permanent establishments belonging to the same GE and other specified associated enterprises. In our considered view, this fictional independence under Article 7(2) does not travel beyond the transactions with entities other than the GE, and the PEs belonging to the same GE.

125. The fiction of hypothetical independence, as set out in Article 7(2), has no role to play in adjusting actual revenues with independent entities. As is clearly set out in that treaty provision itself, it refers for transactions at arm's length only "***with the enterprise of which it is permanent establishment***" and the scope of enterprise in this context would include the entire general enterprise, including its other permanent establishments (i.e. GE and other PEs belonging to the same GE). The very concept of adjustment for arms length price relates only to associated enterprise, as, on a conceptual note, an arms length price adjustments, in computation of PE profits, only seek to nullify the impact of PE's proximity and interrelationship with other associated enterprises, including its GE and its PEs belonging to its GE. There is no support whatsoever for the proposition that this arms length principle must also

be extended to independent entities. The words of Article 7(2) are clear and unambiguous.

126. Learned counsel's argument seem to suggest that the transactions with the clients should be seen in two compartments – first, transactions of the clients with the GE, i.e. when client assigns the professional work to the GE; and – second, the GE deputing the PE to do this work, i.e. when the work is assigned by the GE to the Indian PE. That splitting of a transaction will be wholly artificial and devoid of any rationale basis, nor can it be recognized for the purposes of computing the profits attributable to the PE. When actual bills in respect of the services rendered are raised in respect of the work done by the PE and the same are realized from an outside party, it cannot be contended that these actual realizations should be substituted by some hypothetical figures merely because if the assessee had to do the same work for its GE, it would have accounted for such hypothetical amount. The adjustments can at best be made for actual GE -PE and for PEs *inter se* transactions, and, by no stretch of logic, transactions with the independent enterprises cannot be covered by such adjustments.

127. Even otherwise, this fictional PE is created as a result of the deputation of staff and partners by the GE, and, the event triggering the PE coming into existence is after the assignment begins. It cannot, therefore, be said that there were GE-PE transactions, with regard to the assignment with the work, when PE was not even in existence. The fiction of Article 7(2) is restricted to dealings with GE, including other PEs belonging to the same GE, and there cannot be another fiction in applying this provision to the effect that the dealings with the outside parties should also be deemed to have been entered into with the GE because

these dealings involve a role for such GE as well.

128. Even with respect to the transactions covered by the fiction of Article 7(2), which, we must emphasize are only intra organization or intra associated enterprises transactions, the issue does arises as to what degree this fictional independence can be stretched. It could possibly be argued that the intra organization transactions should be valued at the prevailing market price in ideal conditions, while it is also a recognized approach to the issue that the fiction of hypothetical independence merely permits taking into account the intra organization transactions, at the normal transaction value, which was otherwise impermissible under the law of contracts. Prof Klaus Vogel describes the former approach as of 'absolute hypothetical independence' and the latter approach as of 'restricted independence'. There is a school of thought, which is recognized by Prof Vogel and which has also found favour with several European judicial authorities- as mentioned by Prof Vogel in his book 'Klaus Vogel on Double Taxation Conventions', that the connotations of hypothetical independence are confined to, what he terms as, 'restricted independence'. Of course, even in this scenario tax authorities can adjust the transaction values when they find that the same are in consonance with the arms length prices, and, as such, distort the PE profit computation, but the substitution of real transaction value by an ideal transaction value in the perfect market conditions, so as to reflect profitability in ideal conditions, can not be permissible. Lets not forget that the end purpose of entire exercise of PE profit computation is a fair allocation of taxability of an income in related tax jurisdictions, and not computation of possible profits of the PE in perfect market conditions. Viewed in this perspective, in any event, the fiction of hypothetical independence would not permit the transactions between various limbs

of GE to be taken as artificial prices. The adjustment contemplated in Article 7(2) are to prevent the manipulation of tax base, and neutralize any efforts to vitiate computation of PE profits by way of inappropriate valuation of transaction values in respect of intra organization transactions, rather than being the mechanism to maneuver such manipulation.

129. The other aspect of the matter is that in case all transactions in PE are at arms length price – whether with the associated enterprise or by routing transactions notionally through the GE, PE will never reflect actual profits attributable to PE. The GE PE profit computation approach will then be, as what can be termed as, octopus approach in which GE is seen as mouth of octopus, whereas all PEs are viewed as sort of arms of that feed the mouth i.e. center or the GE. In this fiction of octopus theory, the enterprise is seen as consisting of a productive center where the bulk of activities and brainpower are situated and a series of tentacles thus provide sustenance to the center. In this approach, residual profits, i.e. actual profits of the GE over and above the minimal mark ups, will always belong to GE. An alternate paradigm could be to view GE PE relationship as a somewhat linear relationship, which can be compared to a relay or rowing race in which contribution of each of the profit center is seen as contributing to overall goal and no particular limb of the organization has a right of residual profits. The residual is neither given to the anchor of the relay team nor to the stroke of the eight. There are several good reasons for adopting this linear approach to allocation of residual profits because, if nothing else, in today's interdependent world, PEs are to be seen as an integral and essential part of the businesses as a whole, and, not as mere colonies or support systems of the GE. On a balancing note, however, as long as

FAR (function, assets and risk) analysis is possible in each of the tax jurisdiction involved, neither there is a need to resort to rather colonial octopus approach, nor is there any need of banking upon a somewhat over simplistic linear approach. In such a situation, profit allocation can be on a more rational and justified basis of FAR analysis of establishment or activity in each tax jurisdiction. Therefore, even when it is a GE PE transaction, the residual profit cannot always be allocated straight away to the general enterprise, as a simplistic revaluation of transaction values on the basis of market prices will inherently involve, and the allocation of profits over GE and PEs have to be on an equitable and rationale basis. Be that as it may, it is not really necessary to go any deeper into this aspect of the matter, in view of our categorical finding to the effect that the transactions in questions in respect of which revenues are sought to be modified on the basis of arms length principle, on the facts of this case, are transactions with the independent enterprises, whereas arms length principle is relevant only for intra organization transactions or transactions with associated enterprises. Accordingly, the assessee has wrongly invoked the independence fiction under Article 7(2) to revalue the figures of revenues generated by the permanent establishment.

130. In view of the above discussions, in our considered view, the very plea of the assessee proceeds on fallacy that arms length price adjustment can be made in respect of the transactions with the clients of the assessee. The revenues earned by the assessee are to be taken at actual figures and no adjustments are permissible in the same. We reject this plea of the assessee as well. The action of the authorities below is confirmed on this count as well.

Taxability of reimbursement of expenditure by resorting to adhoc disallowance @ 15% of expenditure claimed to have been incurred

131. We have noted that while Assessing Officer noted assessee's claim that the reimbursements of expenses are in respect of actual expenditure incurred by the assessee, on behalf of clients, and have no element of mark up or income, he treated 50% of such reimbursements of expenditure as income on the ground that "the assessee has not been able to produce all such bills/ invoices and considering the facts these bills do not, in any case, have any supporting evidences" and thus brought to tax an amount of Rs 2,12,23,219, the CIT(A) upheld the action of the Assessing Officer to the extent of 15% of the total amount of reimbursement. The CIT(A) also held that the reimbursements of expenses received by the assessee constitute income of the assessee. It is also important to bear in mind the fact that the CIT(A) confirmed the disallowance of 15% of reimbursement of expenses on the ground that (a) the appellant was not able to produce all supporting evidences in respect of expenditure incurred; and (b) it may be difficult to bifurcate the expenses between disbursements related to services rendered in India and services rendered outside India. While the Assessing Officer is not in appeal against the disallowance so restricted by the CIT(A), the assessee is not satisfied by the part relief given by the CIT(A) and is in second appeal before us.

132. Learned counsel has taken us through meticulous documentation in respect of reimbursements of expenses, and also produced before us samples of supporting evidences in respect of each

claim of reimbursement of expenses. He has also extensively referred to the prevailing regulation in the United Kingdom which ensure strict control over possible inflation of such reimbursement claims, as also to the internal control mechanism in respect of these claims. He submits that all requisitions of the authorities below, in respect of supporting evidences for such claims, have been duly complied with, and the CIT(A) has confirmed the partial disallowance only on surmises and conjectures. He urges us to delete the disallowance confirmed by the CIT(A) and hold that the reimbursements of expenses received by the assessee, particularly on the facts of the case, cannot be treated as income in the hands of the assessee. Learned Departmental Representative, on the other hand, relies upon the orders of the authorities below and submits that the onus is on the assessee to produce all the evidences of expenditure and that this onus is clearly not discharged by the assessee.

133. Having heard the rival submissions and having perused the material on record, we are inclined to uphold the grievance of the assessee. The reimbursements received by the assessee are in respect of specific and actual expenses incurred by the assessee and donot involve any mark up, there is reasonable control mechanism in place to ensure that these claims are not inflated, and the assessee has furnished sufficient evidence to demonstrate the incurring of expenses. There is thus no good reason to make any addition to income in respect of these reimbursements of expenses. The action of the CIT(A), as learned counsel rightly contends, on pure surmises and conjectures. In view of the above discussions, we direct the Assessing Officer delete the disallowance of expenses as sustained by the CIT(A) and hold that no part of reimbursements of expenses received by the assessee, on the facts of this case, be treated as income of the assessee. The assessee gets the relief accordingly.

On quashing the initiation of penalty proceedings

134. The assessee has raised a ground of appeal seeking the quashing of penalty proceedings, but, as this ground is not pressed, the same is dismissed as infructuous.

Outcome of assessee's appeal

135. In the result, the appeal filed by the assessee is partly allowed in the terms indicated above.

Levy of interest under section 234 B of the Act

136. In the appeal filed by the Assessing Officer, a grievance has been raised against CIT(A)'s holding that, interest u/s 234B of the Act was not chargeable in the case of assessee, as all sums chargeable to tax in the hands of the assessee are liable to deduction of tax at source u/s 195 of the Act.

137. Learned representatives fairly agree that the issue is now covered in favour of the assessee by a large number of decisions of the Tribunal, including Special Bench decision in the case of Motorola Inc Vs DCIT (95 ITD SB 269) which has since been approved by the Hon'ble jurisdictional High Court in the case of DIT Vs NGC Network LLC (313 ITR 187). Learned Departmental Representative, nevertheless, dutifully relies upon the order of the Assessing Officer.

138. Respectfully following the esteemed views of Hon'ble jurisdictional High Curt in the case of NGC Network LLC (supra), we approve the conclusions arrived at by the CIT(A) and decline to interfere on the matter on this count as well. Ground No. 1 of the Assessing Officer is thus rejected.

Application of force of attraction principle in computation of profits attributable to the PE.

139. The only other grievance raised in Assessing Officer's appeal is that the CIT(A) erred in holding the assessee was taxable in respect of only that portion of income that was related to services performed in India, and did not appreciate the scope of "force of attraction" principle embedded in Article 7 (1) of the India-UK tax treaty.

140. As we have seen earlier in this order, the impugned relief given by the CIT(A) was for three reasons reasons – first, the twin factors that the "income earned by the appellant were not in the nature of fees for technical services as defined in section 9(1)(vii) and therefore the AAR Ruling in the case of Steffen, Roberstson & Kirsten Consulting Engineers (supra) will not apply to the facts of the appellant" and that " as per Explanation (a) to Section 9(1)(i), even if there is a business connection in India, only income related to operations carried out in India is taxable in India"; - second, that "in the case of Clifford Chance (82 ITD 106) the Hon'ble Mumbai Bench of ITAT has held that the income relating to services rendered outside India is not taxable in India"; and – third, that "as per Article 7, only that portion of income, which is attributable to the

permanent establishment in India, can be taxed in India".

141. Having heard the rival contentions, and having carefully considered factual matrix of the case as also the applicable legal position, we find that none of these three reasons are sustainable in law.

142. As far as fist reason, or rather set of reasons, adopted by the CIT(A),these reasons no longer hold good in law in view of legal position as a result of retrospective legal amendment in the scheme of Section 9. Even prior to the retrospective amendment, the same interpretation about the legal position was approved by the Hon'ble Authority for Advance Ruling. As was noted by Hon'ble Authority for Advance Ruling in the case of Steffen, Robertson & Kirsten Consulting Engineers & Scientists, *In Re* (230 ITR 206), "A careful reading of Section 9, together with the Explanations thereto, makes it clear that the statutory test for determining the place of accrual of income is not the place where these services are rendered but where those services are utilized". Whether the accrual of income is in respect of fees for technical services or in respect of professional fees, that does not alter the nature of deeming fiction under Section 9(1) of the Income Tax Act. This position is further fortified by the retrospective amendment to Section 9(1) by insertion of new Explanation thereto. We have discussed the issue of taxability under the domestic law, which includes detailed analysis of the provisions of Section 9(1), in paragraphs 14 to 19 of this order. In this analysis, we have held that, under the provisions of the Indian Income Tax Act, the entire income from professional services sourced from India, whether in respect of the services rendered in India or outside India, is taxable in India. In this view of the matter the reasoning adopted by the CIT(A), so far as it related to the provisions of the Indian Income Tax Act, does not hold good in law, and it cannot be sustained by us.

143. As regards CIT(A)'s reliance on Clifford Chance decision by this Tribunal, the said decision has now merged in the Hon'ble Bombay High Court's judgment in the case of Clifford Chance Vs DCIT (supra), and, for the detailed reasons set out earlier in this order in paragraphs 14 to 19 and in view of the legal position as it stands now, Hon'ble Bombay High Court's judgment in Clifford Chance case (supra) does not hold good in law

144. As far as learned CIT(A)'s reliance on Article 7(1) of the India UK tax treaty is concerned, in support of the proposition that only such profits as attributable to the operations carried out in the PE are taxable in India, this is simply contrary to the plain provisions of the India UK tax treaty. Article 7, as we have seen earlier in this order, provides that if the enterprise carries on business through a PE, the profits of the enterprise may be taxed in the other State but only so much of them as is "directly or indirectly attributable to that permanent establishment".

145. Learned CIT(A) has apparently taken note of the profits in respect of the work performed in the PE itself but he has not taken note of the position that it is only in respect of the profits directly attributable to work done in the PE but it is in respect of profits "directly" or even "indirectly" attributable to the permanent establishment. The import of "directly or indirectly attributable to PE" has been clearly ignored. The inclusion of 'profits indirectly attributable to the PE' clearly incorporates a force of attraction principle in the India UK tax treaty, but the CIT(A) has simply not taken note of that aspect of the matter. In the impugned order, the CIT(A) has, *inter alia*, observed that, "I also agree with the learned A.R's arguments that as per Article 7, only that portion of income,

which is attributable to the permanent establishment in India, can be taxed in India", and that, "……….only that portion of income relating to rendering of such services in India can be attributed to the services PE of the appellant in India". This approach of the CIT(A) is clearly incompatible the force of attraction rule embedded in Article 7(2) of India UK tax treaty. In this view of the matter, We cannot, and do not, approve the action of the CIT(A) in this respect.

146. The extension of taxability of profits of PE by including profits directly or indirectly attributable, is akin to the provisions of Article 7(1)(b) and 7(1)(c) of the UN Model Convention which provides that in addition to the "profits attributable to the permanent establishment" the taxability of PE profits will also extend to "(b) sales in that other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment; or (c) other business activities carried on in that other State of the same or similar kind as those effected through that permanent establishment". In our considered view, the connotations of "profits indirectly attributable to permanent establishment" will extend to these two categories. These categories clearly incorporates a force of attraction rule. The basic philosophy underlying the force of attraction rule is that when an enterprise sets up a permanent establishment in another country, it brings itself within the fiscal jurisdiction of that another country to such a degree that such another country can properly tax all profits that the enterprise derives from that country - whether the transactions are routed and performed through the PE or not.

147. The provisions of Article 7(1) in India UK tax treaty include the same results as sought to be achieved by Article 7(1)(c) of the UN

Model Convention. As to the scope of this provision, we find guidance from the UN Model Convention Commentary in this regard. On this issue, the UN Model Convention Commentary states, inter alia, as follows

> ***………………Some members from developed countries pointed out that the "force of attraction" rule had been found unsatisfactory and abandoned in recent tax treaties concluded by them because of the undesirability of taxing income from an activity that was totally unrelated to the establishment and that was in itself not extensive enough to constitute a permanent establishment. They also stressed the uncertainty that such an approach would create for taxpayers. Members from developing countries pointed out that the proposed "force of attraction" approach did remove some administrative problems in that it made it unnecessary to determine whether particular activities were or were not related to the permanent establishment or the income involved attributable to it. That was the case especially with respect to transactions conducted directly by the home office within the country, but similar in nature to those conducted by the permanent establishment. However, after discussion, it was proposed that the "force of attraction" rule, should be limited so that it would apply to sales of goods or merchandise and other business activities in the following manner: if an enterprise has a permanent establishment in the other Contracting State for the purpose of selling goods or merchandise, sales of the same or a similar kind may be taxed in that State even if they are not conducted through the permanent establishment; a similar rule will apply if the permanent establishment is used for other business activities and the same or similar activities are performed without any connection with the permanent establishment.***

(Emphasis supplied by us)

148. In our considered view, therefore, the connotations of "profits indirectly attributable to permanent establishment" do indeed extend to incorporation of the force of attraction rule being embedded in Article 7(1). The way it needs to be implemented, on the facts of the present case, is like this. In addition to taxability of income in respect of

services rendered by the PE in India, any income in respect of the services rendered to an Indian project, which is similar to the services rendered by the permanent establishment, is also to be taxed in India in the hands of the assessee – irrespective of the fact whether such services are rendered through the permanent establishment, or directly by the general enterprise. There cannot be any professional services rendered in India which are not, at least indirectly, attributable to carrying out professional work in India. This indirect attribution, in view of the specific provisions of India UK tax treaty, is enough to bring the income from such services within ambit of taxability in India. The twin conditions to be thus satisfied for taxability of related profits are (i) the services should be similar or relatable to the services rendered by the PE in India; and (ii) the services should be 'directly or indirectly attributable to the Indian PE' i.e. rendered to a project or client in India. In effect thus, entire profits relating to services rendered by the assessee, whether rendered in India or outside India, in respect of Indian projects is taxable in India. That is precisely what the Assessing Officer had done. The grievance of the Assessing Officer is indeed justified and we uphold the same. We, therefore, vacate the relief granted by the Commissioner (Appeals) and restore the order of the Assessing Officer in this regard.

149. In this view of the matter, second ground of appeal of the Assessing Officer is thus allowed.

Outcome of Assessing Officer's appeal

150. In the result, appeal filed by the revenue is partly allowed in the terms indicated above.

Summary of outcome of cross appeals

151. To sum up, the appeals filed by the assessee as also by the Assessing Officer are partly allowed in the terms indicated above. Pronounced in the open court today on 16th day of July, 2010.

Sd/xx	Sd/xx
(R S Padvekar)	**(Pramod Kumar)**
Judicial Member	**Accountant Member**

Mumbai; 16th day of July, 2010

Copy forwarded to :

1. *The appellant*
2. *The respondent*
3. *The Assessing Officer*
4. *Director of Income Tax (International Taxation), Mumbai*
5. *Commissioner (Appeals) , Mumbai*
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