Foreign law firms providing services in India

PwC Law Firm Services

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Introduction

A recent case heard before the Income Tax Appellate Tribunal in Mumbai has provided some clarity to foreign law firms providing services in India.

The case (ADIT v. Clifford Chance) considered the application of the India-UK Tax Treaty to partnerships and the relevance of the 'force of attraction' principal.

The tribunal found in favour of the law firm, holding that

1. Firstly, the income of the law firm related to India would be taxable only to the extent attributable to services performed in India; and

2. That, in interpreting Article 7(1) of the India-U.K. Tax Treaty as it relates to businesses with a permanent establishment in India, consideration attributable to services rendered in the resident State (UK) is not taxable in the source State (India).

The case

UK law firm's position

The U.K. law firm's position was that Article 15 of the India-U.K. Tax Treaty, concerning independent personal services, applied to the income at issue, and that the law firm had not created any permanent establishment ("PE") in India. For the tax years when the attorneys remained in India for more than 90 days, the law firm argued, only income from professional services that were performed in the country was taxable in India, a position consistent with the longstanding "territorial nexus" doctrine that the High Court affirmed in favour of the U.K. firm in a 2009 decision.

Department of Revenue's argument

The Department of Revenue argued that Article 15 of the treaty only applied to individuals, not law firm partnerships, and that the U.K. firm's activities in India created a PE whereby the profit earned by the assessee from the rendering of services in India was taxable as a business profit under Article 7(1) of the India-U.K. Tax Treaty. Furthermore, the Department of Revenue argued that the entire fee received by the U.K. firm from clients for services rendered inside and outside India was chargeable to tax in India as such services were utilized in relation to the projects in India.

For UK businesses that have a PE in India, Article 7(1) of the India-U.K. Treaty provides that the profits of the business shall be taxable in India to the extent of profits directly or indirectly attributable to such PE. The Department of Revenue's interpretation of "directly or indirectly attributable" as embodied in its legal argument is consistent with the 'force of attraction' principle incorporated by section 7(1)(b) and 7(1)(c) of the UN Model Convention.

The issues addressed by the recent Order involved questions of law decided by a co-ordinate bench in the case of Linklaters LLP v. ITO [2010] 40 SOT 51 (Mum). One of the issues in that case was The Finance Act, 2010, with retroactive effect from June 1, 1976. That legislation amended an explanatory provision stating that income earned by a non-resident under Section 9(1)(v) (interest), (vi) (royalties), and (vii) (fees for technical services) of the Income Tax Act of 1961 shall

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be deemed to accrue or arise in India whether or not the non-resident has a residence, place of business or business connection, and regardless of whether the non-resident has rendered services in India.

The co-ordinate Bench interpreted this amendment as applying to professional services as 'technical services' (clause vii). Therefore, the co-ordinate Bench decided that a prior High Court decision with respect to the assessee, which held that services must be both utilized in India and rendered in India to be taxable, was no longer good law. The co-ordinate Bench also decided that the 'force of attraction' rule was applicable in interpreting "directly or indirectly attributable" for purposes of Article 7(1) of the India-U.K. Tax Treaty, as they determined such provision was akin to Article 7(1)(b) and 7(1)(c) of the UN Model Convention. Therefore, under the 'force of attraction' rule as applied to the law firm in the Linklaters case, income earned from services rendered in India as well as outside India was includable in taxable income of the PE.

Tribunal's opinion

The Tribunal did not concur with the earlier Linklaters' decision. The Special Bench held that the amendment brought by the Finance Act, 2010 only applied to the three categories of income described therein, interest, royalties, and fees for technical services. Professional services income, the Special Bench held, which are properly included in clause (i) of the Income Tax Act of 1961, were not affected by the amendment. As a result:

- The High Court's 2009 decision in Clifford Chance v. DIT [2009] 176 Taxman 485 (Bom) remained good law in so holding that services must be both rendered in India and utilized in country in order to satisfy the "territorial nexus" doctrine.
- Although the Special Bench made no determination as to the presence or absence of a PE during any relevant year, the Special Bench held that the calculation of taxable income includes only those amounts specifically described as includable pursuant to Article 7(3) of the India-U.K. Tax Treaty, and as this provision was definite and unambiguous, the co-ordinate Bench's reference to Article 7(1) of the UN Model Convention in the Linklaters opinion was unnecessary, and thus the 'force of nature' principle embodied therein was inapplicable.

Summary

The case has provided some clarity surrounding the amendment brought by the Finance Act 2010, concluding that income of a non-resident law firm performing services in India is only taxable in India to the extent that the work is attributable to a Permanent Establishment of the firm in India.

It should be noted that the tax authorities have a right to appeal this ruling to the High Court and it is likely that this will happen. After any appeal to the High Court, the case can be escalated to the Supreme Court. A decision of the Supreme Court is generally final.

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