FEDERAL COURT OF AUSTRALIA

Tech Mahindra Limited v Commissioner of Taxation

[2016] FCAFC 130

Appeal from:	*Tech Mahindra Limited v Commissioner of Taxation* [2015] FCA 1082
File number:	NSD 1699 of 2015
Judges:	**ROBERTSON, DAVIES AND WIGNEY JJ**
Date of judgment:	22 September 2016
Catchwords:	**TAXATION** – allocation of taxing rights – interaction between Art 7 and Art 12 of the *Agreement between the Government of Australia and the Government of the Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income 1991* [1991] ATS 49 — operation of Art 7 "business profits rule" – operation of Art 12 " the royalties provision"– whether Art 12(4) on its proper construction applied to royalties – whether source State has a right to tax royalties under Art 7 or Art 12
Legislation:	*Agreement between the Government of Australia and the Government of the Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income 1991* [1991] ATS 49, Art 7 and Art 12 *International Tax Agreements Act 1953* (Cth), s 11Z *Vienna Convention on the Law of Treaties* [1974] ATS 2, Art 31
Cases cited:	*McDermott Industries (Aust) Pty Ltd v Commissioner of Taxation* (2005) 142 FCR 134; [2005] FCAFC 67 *Task Technology Pty Ltd v Federal Commissioner of Taxation* (2014) 224 FCR 355; [2014] FCAFC 113
Date of hearing:	9 August 2016
Registry:	New South Wales
Division:	General Division
National Practice Area:	Taxation

Category:	Catchwords
Number of paragraphs:	44
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ORDERS

NSD 1699 of 2015

BETWEEN:	**TECH MAHINDRA LIMITED** Appellant
AND:	**COMMISSIONER OF TAXATION** Respondent
JUDGES:	**ROBERTSON, DAVIES AND WIGNEY JJ**
DATE OF ORDER:	**22 SEPTEMBER 2016**

THE COURT ORDERS THAT:

1. The appeal be dismissed.

2. The Appellant pay the Respondent's costs of and incidental to the Appeal.

Note: Entry of orders is dealt with in Rule 39.32 of the *Federal Court Rules 2011*.

REASONS FOR JUDGMENT

THE COURT:

INTRODUCTION

1 This appeal concerns Article 7 (the business profits rule) and Article 12 (the royalties provision) of the *Agreement between the Government of Australia and the Government of the Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income,* concluded 25 July 1991, [1991] ATS 49 (entered into force 30 December 1991) (**"the Indian Treaty"**).

2 The Appellant is a resident of India which carries on business in Australia through a permanent establishment. In the income year in issue, the Appellant performed services for its Australian customers both in Australia and in India. The Appellant did not dispute that Article 7(1)(a) of the Indian Treaty gave Australia the right to tax the income that the Appellant received in respect of the services performed in Australia, but in issue was whether Australia had any taxing rights in respect of the income from the services performed by the Appellant in India (**"the Indian services"**). The respondent (**"the Commissioner"**) contended that the payments in respect of the Indian services were "royalties" as defined in Art 12(3) and taxable in Australia under Art 12(2) and, in the alternative, that the net profits from the Indian services were liable to Australian tax under Article 7(1)(b) of the Indian Treaty. The Appellant in turn contended that the payments were not "royalties" as defined in Art 12(3) but, if royalties, Art 12(4) was engaged and gave priority to Art 7, so that whether Australia had the right to tax those payments depended on whether the criteria in Art 7(1) were met which, it was submitted, they were not. It was common ground that the profits referable to the Indian services were not attributable to the Appellant's permanent establishment in Australia and that Australia did not have taxing rights in respect of those profits under Art 7(1)(a).

3 The primary judge held that certain categories of payments referrable to the Indian services were "royalties" within the meaning of that term as defined in Art 12(3)(g) and held also that Art 12(4) was not engaged, so that Australia had the right to tax those payments under Art 12(2) of the Indian Treaty. The Appellant has appealed the decision of the primary judge that Art 12(4) was not engaged but not the finding that certain categories of payments referrable to the Indian services were "royalties" within the meaning of that term as defined

in Art 12(3)(g). For the reasons that follow we agree with the primary judge that Art 12(4) of the Indian Treaty was not engaged.

THE INDIAN TREATY

4 The Indian Treaty is set out in Schedule 35 to the *International Tax Agreements Act 1953* (Cth), and incorporated into Australian domestic law pursuant to s 11Z of that Act.

5 Article 7 of the Indian Treaty relevantly provides:

> *Business Profits*
>
> (1) The profits of an enterprise of one of the Contracting States shall be taxable only in that State unless the enterprise carries on business in the other Contracting State 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 attributable to:
>
> (a) that permanent establishment; or
>
> (b) sales within that other Contracting States of goods or merchandise of the same or a similar kind as those sold, or other business activities of the same or a similar kind as those carried on, through that permanent establishment.
>
> ...
>
> (3) In the determination of the profits of a permanent establishment, there shall be allowed as deductions...expenses of the enterprise...
>
> ...
>
> (7) Where profits include items of income which are dealt with separately in other Articles of this Agreement, then the provisions of those Articles shall not be affected by the provisions of this Article.

6 Article 12 relevantly provides:

> *Royalties*
>
> (1) Royalties arising in one of the Contracting States, being royalties to which a resident of the other Contracting State is beneficially entitled, may be taxed in that other State.
>
> (2) Such royalties may also be taxed in the Contracting State in which they arise, and according to the law of that State, but the tax so charged shall not exceed:
>
> ...
>
> (b) in the case of other royalties:
>
> (i) during the first five years of income for which this agreement has effect:
>
> ...

B. in all other cases: 20% of the gross amount of the royalties; and

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

(3) The term "royalties" in this Article means payments or credits, whether periodical or not, and however described or computed, to the extent to which they are made as consideration for:

...

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

...

(4) The provisions of paragraphs (1) and (2) shall not apply if the person beneficially entitled to the royalties, being a resident of one of the Contracting States, carries on business in the other Contracting State, in which the royalties arise, through a permanent establishment situated therein, or performs in that other State independent of personal services from a fixed base situated therein, and the property, right or services in respect of which the royalties are paid or credited are ***effectively connected with*** such permanent establishment or fixed base. In such a case, the provisions of Article 7 ... shall apply.

...

(emphasis added)

7 Whether Art 12(4) applied thus depends upon whether the Indian services in respect of which the royalties were paid to the Appellant were "effectively connected with" its permanent establishment in Australia.

DECISION BELOW

8 Before the primary judge, the Appellant argued that Article 12(4) was engaged because the Indian services in respect of which the royalties were paid were "effectively connected" to its permanent establishment. First it was said that the Appellant's contractual arrangements with the Australian customers defined both the scope of the services to be provided to the customers, and the Appellant's entitlement to be paid for those services, and the contractual rights which gave rise to the payments thus served to effect the purpose of the permanent establishment in that they provided the essential foundation for the business activities carried on by the Appellant in Australia through the permanent establishment. Secondly, it was submitted that the Indian services were performed in concert with the services performed through the permanent establishment, such that it was only the Indian services in combination

with the Australian services that together satisfied the contractual obligations to the Australian customers. The close relationship was said to have the consequence that the Indian services were effectively connected with the permanent establishment.

9 The Commissioner argued that Art 12(4) is co-extensive with Art 7(1)(a) and that the relevant "property, right or services in respect of which the royalties are paid" are "effectively connected with [the permanent establishment]" where the profits from such services are "attributable to [the] permanent establishment". It was argued that Article 12(4) gave priority to Article 7 where the criteria in Article 7(1)(a) were met so as to give Australia the right to tax the royalties as part of the profits of the permanent establishment, instead of at the capped rate under Art 12.

10 The primary judge accepted the Commissioner's construction. First her Honour reasoned that the purpose of Art 12(4) was "manifestly" to entitle the source State where the royalties arise to impose tax on those "royalties" at the potentially more generous rates permitted under Art 7(1), rather than the capped rate under Art 12(2), where there is an effective connection between the payments and the permanent establishment in the source State through which the non-resident carries on business. Secondly her Honour accepted that the words "effectively connected" with the permanent establishment are intended to encapsulate in a shorthand way the different tests of connection under Art 7(1)(a) (and Article 14) which were regarded as sufficient justification for permitting a Contracting State to tax profits of an entity notwithstanding that it is not a resident of that State. Thirdly, her Honour considered that the Appellant's construction left the concept of "effectively connected" undefined. Fourthly, her Honour considered that the Commissioner's construction was consistent with the decision in *McDermott Industries (Aust) Pty Ltd v Commissioner of Taxation* (2005) 142 FCR 134; [2005] FCAFC 67 which considered Art 10 of the double taxation agreement between Australia and Singapore (equivalent to Art 12 of the Indian Treaty).

11 The primary judge also held that if however the Appellant's construction was the correct construction, then the profits from the Indian services in the relevant year were not liable to tax by Australia under Art 7.

THE APPEAL

12 The sole issue in the appeal concerns the proper construction of Art 12(4). The Appellant did not challenge the finding below that certain of the payments in question constituted "royalties" as defined in Art 12(3) and the Commissioner did not seek to challenge the

finding that Art 7 would not apply to those payments if the Appellant's construction was the correct construction.

The Appellant's submissions

13 It was argued for the Appellant that the approach of the primary judge to the meaning of "effectively connected with" in Art 12(4) was in error.

14 First it was submitted that the Commissioner's argument as to construction (accepted by the primary judge) was based not upon the language used in Art 12(4), but upon an assumption that the purpose of Art 12(4) was to remove royalties from Art 12 only if the source State had the right to tax such royalties pursuant to Art 7(1)(a). It was submitted that that was not the language of Art 12(4) and that Art 12(4) must be construed in accordance with the language used.

15 Secondly, it was submitted that the expression "effectively connected with" in Art 12(4) connotes in ordinary language a connection which serves to effect the purposes of the permanent establishment. It was submitted that the evident intent of Article 12(4) is that where an effective connection exists, the payments are not to be dealt with under the treaty as "royalties", but are "assimilated" to business profits and on that basis, whether they are taxable in Australia will then depend upon the operation of the business profits provision in Art 7 of the Indian Treaty.

16 Thirdly, it was submitted that the context of Art 12(4) is the allocation of taxing rights. The context includes cognate provisions in Articles 10(4) (relating to dividends), 11(4) (relating to interest), and 22(3) (relating to items of income not expressly mentioned). It was submitted that the result of the effective connection with the permanent establishment is that the taxing rights in respect of those payments are not to be allocated by Articles 10, 11, 12 or 22 but are to be allocated by Art 7, that is the dividends, interests, royalties, or other income are to be assimilated with business profits, and the taxing rights with respect to them allocated by Art 7. In turn, whether Art 7 allocates taxing rights depends upon the criteria of that Article.

17 In this case, it was said, Art 12(4) was engaged because the services performed in India contributed to the discharge of contractual obligations undertaken by the Appellant with its Australian customers in relation to the business carried on through the permanent

establishment in Australia and served to effect the purposes of the permanent establishment. It was not in dispute that the profits were not liable to tax by Australia under Art 7(1).

The Commissioner's submissions

18 The Commissioner submitted that the construction for which the Appellant contended was not supported by the language of that provision, or by a consideration of its context in the scheme of the Indian Treaty or having regard to the evident object and purpose of the Indian Treaty as a whole.

19 As a matter of language, it was argued that the phrase "effectively connected" in the context of the words "with such permanent establishment" in ordinary meaning imports an element of causality between the relevant "property, right or services" and the permanent establishment, which reflects the operation of Art 7 (and Art 14). It was also argued that the expression "property, right or services" in Art 12(4) must be read in conjunction with Art 12(3) which defines the "property, right or services" for which the payments are made as consideration and constitute "royalties".

20 It was argued that the purpose of Art 12(4), considered in context, is to give the source State where the royalties arise, the right to tax such royalties under Art 7 in lieu of Art 12 where the property, right or services in respect of which the royalties are paid are effectively connected with that permanent establishment. It was submitted that Art 12(4) has a co-extensive operation with Art 7 with respect to the allocation of taxing rights in respect of royalties, so that such royalties are taxable by Australia pursuant to Art 7, where Art 12 (4) is engaged, or otherwise pursuant to Art 12(2).

CONSIDERATION

21 For the reasons that follow, the primary judge was correct on the construction and application of Art 12(4).

22 The principles to apply in the interpretation of the Article were not in dispute and are well settled. A holistic approach is to be taken to the interpretation of the Indian Treaty, in line with the rule of interpretation in Article 31 of the *Vienna Convention on the Law of Treaties,* opened for signature 23 May 1969, [1974] ATS 2 (entered into force 27 January 1980). The written text has primacy but the Court must also have regard to the context, object and purpose of the treaty provisions: *Task Technology Pty Ltd v Federal Commissioner of Taxation* (2014) 224 FCR 355; [2014] FCAFC 113 at [12].

23 The essential competing difference in construction between the parties is whether Art 12(4) is simply a gateway to Art 7 so that whether the source State will have taxing rights under Art 7 will depend on whether the royalties "assimilated" to business profits are, relevantly, attributable to the permanent establishment in the source State through which enterprise carries on business. On the construction argued by the Appellant, a royalty may fall outside of the scope of the source State's right to tax by virtue of Art 12(4), if Art 7 does not give taxing rights to the source State in respect of that royalty. The context and evident purpose of Art 12(4) does not give support for that construction.

24 In construing Art 12(4), it is important to consider how Art 7 and Art 12 interact.

25 Art 7 allocates taxing rights in respect of business profits. Subject to Art 7(7), the right to tax business profits is allocated to the enterprise's country of residence unless the enterprise carries on business through a permanent establishment in the other state. If there is a permanent establishment in the other state, that other state is allocated the right to tax the profits of the enterprise that are "attributable to" the permanent establishment: Art 7(1)(a).

26 The application of Art 7 is subject to Article 7(7) which provides that:

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

27 The allocation of taxing rights with respect to particular items of income, which include royalties, are dealt with under other Articles. Art 7(7) expressly contemplates that business profits will include items of income dealt with under other specific Articles. Article 12 deals with the allocation of taxing rights in respect of amounts that constitute royalties as defined in Article 12(3). Under Art 12, if an item of income constitutes a "royalty" as defined in Art 12(3), both the country of residence and the state of source where the royalties arise have the right to tax the royalties: Art 12(1) and (2). Under Art 12(2), the source State has the right to tax such royalties whether or not attributable to a permanent establishment in that state.

28 The application of Art 12(1) and (2) is subject to Art 12(4), which provides that:

> The provisions of paragraphs (1) and (2) [of Art 12] shall not apply if the person beneficially entitled to the royalties, being a resident of one of the Contracting States, carries on business in the other Contracting State, in which the royalties arise, through a permanent establishment situated therein, or performs in that other State independent of personal services from a fixed base situated therein, and the property, right or services in respect of which the royalties are paid or credited are effectively

> connected with such permanent establishment or fixed base. In such a case, the provisions of Article 7 … shall apply.

29 Therefore there is circularity: the application of the business profits rule in Art 7(1) is subject to Art 7(7); where business profits include "royalties", Art 7(7) is subject to Art 12(4) which has the effect that Art 7, not Art 12, will be applicable. It is evident that Art 7 is to apply to:

(1) business profits of an enterprise not covered by Art 12 that are attributable to a permanent establishment; and

(2) by Art 12(4), also to such of the business profits that are royalties where "the property, right or services in respect of which the royalties are paid or credited are effectively connected with" that permanent establishment.

As a matter of construction, the "property, right or services in respect of which the royalties are paid or credited" referred to in Art 12(4) must be a reference to the property, rights and services listed in Art 12(3). Otherwise such royalties are to be dealt with under Art 12. Royalties thus are able to be taxed by the source State either as part of business profits under Art 7, where such royalties are attributable to a permanent establishment in that state, or separately under Art 12.

30 In the case of the Indian Treaty, it does matter which Article applies as there is a difference in tax treatment depending on whether Art 7 or Art 12 is applicable. Under Art 7, in calculating the profits of the permanent establishment which may be taxed by the state in which the enterprise has the permanent establishment, a deduction is allowable for expenses that were incurred for the purposes of the permanent establishment, whether incurred in the Contracting State where the permanent establishment is situated or elsewhere: Art 7(3). Under Art 12, a limit is placed on the amount of tax that may be charged by the source State, which is capped at a specified percentage of the gross amount of the royalties (Art 12(2)).

31 Article 12(4) is to be construed in the context that Art 7(7) gives priority to Art 12 over Art 7. Without Article 12(4), royalties forming part of the business profits of an enterprise attributable to a permanent establishment in the source State would be taxable by the source State but subject to a limit on the amount of tax that may be charged. No evident object or purpose is indicated, and none was suggested by the Appellant, for construing Art 12(4) in a way that would disentitle the source State from the right at all to tax a payment otherwise within the scope of Art 12(2) but outside the scope of Art 7. To the contrary, the evident purpose of Art 12(4) is to relieve the source State from the limitation on taxing rights

imposed under Art 12 by taxing such royalties under Art 7, not to disentitle the source State from any taxing rights where otherwise Art 7 would not give such taxing rights. Such a construction gives effect to the language of Art 12(4) and is consistent with the extrinsic materials.

32 In the Explanatory Memorandum to the *Income Tax (International Agreements) Amendment Bill (No 2) 1991* (Cth) to give force in the law of Australia to the Indian Treaty, it was stated at p 16 in relation to Art 7(7) that:

> Paragraph 7 effectively provides that where income is otherwise specifically dealt with under other articles of the agreement the operational effect of those particular articles is not overridden by Article 7. The paragraph thus specifies a general rule of interpretation to the effect that the reference to profits in Article 7 may include categories of income that are the subject of other articles of the agreement. It also specifies that such categories of income are to be **treated in accordance with the terms of those articles and as outside the scope of Article 7, except where otherwise provided, eg by paragraph 4 of Article 10**. (emphasis added)

Paragraph 4 of Article 10 is expressed in similar terms to Art 12(4) in relation to dividends.

33 At p 18 it is stated in relation to Art 10(4) that:

> Paragraph 4 effectively provides that the 15 per cent source country tax rate limit is not to apply to dividends derived by a resident of the other country who has a permanent establishment or fixed base in the country from which the dividends are derived, if the holding giving rise to the dividends is effectively connected with that permanent establishment or fixed base. **Where dividends are so effectively connected, they will be treated as "business profits" or "income from independent personal services" and subject to the source country's tax in accordance with the provisions of Article 7 (Business Profits)** or Article 14 (Independent Personal Services), as the case may be. (emphasis added)

34 At p 24 in relation to Art 12(4), it is stated that:

> As in the case of dividends and interest, it is specified in paragraph 4 of Article 12 that the 10/15/20 percent limitation of tax in the country of origin is not to apply to royalties (as defined in paragraph 3) effectively connected with a permanent establishment or fixed base in that country. Such royalties are to be subject to the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services) as appropriate.

35 The language is somewhat loose in that it is not the royalties that must be effectively connected but the property right or services in respect of which the payment or credit in question is made as consideration. Nonetheless, the explanatory memorandum is confirmatory that the function of Art 12(4) is to remove the limitation on taxing rights under Art 12, not to remove the source country's right to tax such royalties unless otherwise the source country has right to tax such royalties under Art 7.

36 To like effect, the commentary that accompanied the *United Nations Model Double Taxation Convention Between Developed and Developing Countries* in 1980 stated with respect to the equivalent Article:

> The paragraph merely provides that in the State of source the royalties are taxable as part of the profits of the permanent establishment there owned by the beneficiary which is a resident of the other State, if they are paid in respect of rights or property forming part of the assets of the permanent establishment or otherwise effectively connected with that establishment. In that case, **paragraph 3 relieves the State of source of the royalties from any limitations under the Article**. The foregoing explanations accord with those in the commentary on Article 7... (emphasis added)

37 It is sufficiently clear that Art 7 and Art 12(4) have a coextensive operation, in that Art 7(7) contemplates that the business profits of an enterprise may include income covered by Art 12 as a royalty. Those royalties that may be taxed under Art 7 are the payments in respect of property, rights or services "effectively connected with" the permanent establishment of an enterprise in the source State and under Art 7(1)(a), profits that are "attributable to" that permanent establishment are taxable by the source State. This is not to base the construction of Art 12(4) upon an assumption that the purpose of Article 12(4) is to remove royalties from Article 12 only if the source State has the right to tax such royalties pursuant to Art 7(1)(a) but to give effect to the coextensive operation of the Articles.

38 The Commissioner's construction gives a coherent structure to the Indian Treaty and should be accepted.

39 Furthermore, the co-extensive operation of Art 12 and Art 7 give content and meaning to the phrase "effectively connected with" in Art 12(4). The primary judge was correct to hold that the phrase "effectively connected with the permanent establishment" is intended to encapsulate the test of connection under Art 7(1)(a), which justifies the allocation of taxing rights to a Contracting State in respect of the business profits of a non-resident that are attributable to the permanent establishment in that Contracting State. Art 12(4) is engaged where the royalties in question are able to be taxed by the source State under Art 7(1)(a) as part of business profits attributable to a permanent establishment in that state. In the present case it was common ground that the payments referrable to the provision of those services were not attributable to the Appellant's permanent establishment in Australia.

40 Something also needs to be said about the Appellant's argument that Art 12(4) was engaged on the facts in this case because in its ordinary meaning "effectively connected" connotes a connection which serves to effect the purposes of the business of the enterprise carried on

through the permanent establishment. This argument was based on the dictionary definition of the word "effective":

> Adjective: serving to effect the purpose; producing the intended or expected result; effective measures: effective steps towards peace…

41 It was said that the test in Art 12(4) was satisfied because, as the primary judge stated at [72], the Appellant had "rightly contend[ed] that the evidence showed the interweaving of services performed in Australia and in India in furtherance of particular projects". It was submitted that here the services in respect of which the royalties were paid discharged contractual obligations that were undertaken by the Appellant through the permanent establishment and thus served to effect the purposes of the permanent establishment.

42 The text requires a connection between the permanent establishment and the particular property, rights or services "in respect of which the royalties are paid". To constitute a "royalty" the payment or credit, as the case may be, must be made "as consideration for" the use of, other right to use, supply of, or forbearance in respect of the use or supply of, the property or rights referred to in Art 12(3)(a)-(f), or for the rendering of, or for, the services referred to in Art 12(3)(g)-(l). Hence it is necessary first to identify that property, or those rights or services, in respect of which the payments (or credits) are made, which give the payments (or credits) in question the character of "royalties" as defined for the purposes of Art 12. In the present case, the payments in question were held to be royalties because they were made as consideration for the services of the kind in Art 12(3)(g), namely:

> The rendering of any services (including those of technical or other personnel) which make available technical knowledge, experience, skill, knowhow or processes or consist of the development and transfer of a technical plan or design.

43 Thus, the question in the present case is whether the services of the kind in Art 12(3)(g) that the Appellant rendered in India for its Australian customers were "effectively connected with" its permanent establishment in Australia. The word "effectively" in this context qualifies the degree of connection that is required between those services and the permanent establishment to trigger the Article. In ordinary meaning, the word "effective" means "actual" or "existing in fact". Used as an adverb in conjunction with "connected", "effectively connected with" should be understood to mean having a real or actual connection with the activities carried on through the permanent establishment. Whether or not such a connection exists is not answered merely on the basis that the property, rights or services provided "serve to effect the purposes of the permanent establishment".

44 The appeal should accordingly be dismissed, with costs.

I certify that the preceding forty-four (44) numbered paragraphs are a true copy of the Reasons for Judgment herein of the Honourable Justices Robertson, Davies and Wigney.

Associate:

Dated: 22 September 2016