Australian Government
Australian Taxation Office

Tech Mahindra Limited v Commissioner of Taxation (Special leave decision)

Court appealed from: Federal Court of Australia (Full Court)

Tech Mahindra Limited
v. Commissioner of Taxation

Citation(s):
[2016] FCAFC 130
2016 ATC 20-582
[2017] HCATrans 58

Date of decision: 10 March 2017

Result: Special leave to appeal is refused with costs

Special leave application results

A.H. SLATER, QC: If the Court pleases, I appear with my friend, MR I.G. FULLERTON, for the applicant. (instructed by Ernst & Young Law)

MR J.O. HMELNITSKY, SC: If the Court pleases, your Honours, I appear with my learned friend, MR P. AFSHAR MAZANDARAN, for the respondent. (instructed by Australian Government Solicitor)

GAGELER J: Now, Mr Slater, speaking perhaps just for myself, you are here because of this decision of the Supreme Court of India.

MR SLATER: That is one reason, your Honour, yes, certainly we think that is an important point - - -

GAGELER J: Otherwise, the reasoning of the courts below appears to be pretty strong.

MR SLATER: We would challenge that, your Honour, very strongly.

GAGELER J: Very well.

MR SLATER: So, your Honour, we do say that the application raises two matters. One, is the matter going to the Indian decision. I will come back to that, if I may, but I should respond to what your Honour has asked me and that is the - what we say is the other issue it raises which is the structure of Australia's double tax agreements. If I could approach it this way, favouring brevity over precision, it can be said that broadly double tax agreements divide income into three classes. They deal with business profits, they deal with property income and they deal with personal income. This matter is concerned with the boundary between business profits and property income.

Your Honours have read the judgments so if I can condense the facts into a few words. Very briefly, the applicant conducted a software service business, in part, via a permanent establishment in Australia. It received from Australian clients undifferentiated gross fees for services provided both in India and in Australia and it made profits from the provision of those services.

Now, the double tax agreement deals with business profits in Article 7; Article 7 is at page 92 of the application book and the material part - starting at line 8, the material part is this:

The profits of an enterprise of one of the Contracting States shall be taxable only -

if I could paraphrase this to deal with the position of the particular taxpayer - shall be taxable only in India:

unless the enterprise carries on business in [Australia] through a permanent establishment situated -

in Australia and, if so:

the profits of the enterprise may be taxed in [Australia] but only so much of them as is attributable to -

the "permanent establishment". Now, it is common ground that the profits from the services rendered in India were not within Article 7(1)(a) so that Article 7 gave Australia no taxing rights in respect of them.

At first instance, our friends relied on paragraph (b) of Article 7(1) the "limited force of attraction" rule. That reliance was rejected and was not pursued on the appeal. Very late in the argument at first instance, after the close of evidence and after Mr Sullivan had completed his submissions, my friend as counsel for the Commissioner effectively abandoned Article 7(1)(b) and, instead, relied on Article 12. Article 12 - and the ground for doing that was that the gross fees were royalties.

GORDON J: You do not contend otherwise?

MR SLATER: We do not dispute that Article 12(3)(g) is attracted, but there is this point to be made. What Article 12(3)(g) does - and your Honours will find it at page 96 at line 5 - is to then, to be royalties, consideration for:

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 -

Now, the primary judge found that that paragraph was attracted and that is not in contest. He then invoked Article 12(2) which provides - and your Honours will see this at the top of page 95 - that royalties may be taxed, and I put some emphasis on the word "may":

may also be taxed in the Contracting State in which they arise -

I draw your Honours' attention to the word "arise" because the word "arise" is not source, the word "arise" is defined in Article 12(5) which is on page 96. It means paid by a State or a government body or a resident of Australia, it does not mean having their source in Australia.

Now, the significant thing is that Australia does not exercise the liberty given to it by Article 12 in respect of these royalties. Australia does not impose the withholding tax on these royalties. They are not within the definition of "royalties" in section 6 in the 1936 Act. Under the Acts profits, these less costs, are taxed if they have a source in Australia, but in the case of a non-resident, such as the applicant, they are only taxed if they have an Australian source.

It is not in contest that the amounts which are sought to be taxed, the amounts in dispute, have an Indian source, they do not have an Australian source, and they fall outside the ordinary scope of the assessment Acts. Under those Acts, under Australia's domestic law, the revenue from the Indian sources - services, would not be taxed. They would not be taxed as royalties because they are outside the definition and they would not be taxed as profits because they have an Indian source and Article 7 protects them.

GAGELER J: I am sorry, I thought the weight of your argument is on Article 12(4)?

MR SLATER: Yes, I am trying to set a context to this, your Honour.

GORDON J: We have not got there yet.

MR SLATER: I have not quite got there yet. I am sorry if I appear to be going a little slowly, I apologise. Partly, that is because of the way in which the matter was dealt with at first instance. After the evidence had gone and after the argument with the applicant had closed my learned friend in what can only be described as a virtuoso display of forensic pyrotechnics changed his case and concatenated three provisions.

GAGELER J: That is a very colourful description for a tax case really.

MR SLATER: Your Honour, tax cases are often colourful. What he did was to join together paragraphs (2) and (3)(g) of Article 12 and say that Australia may tax amounts which fall within paragraph (3)(g) and then joined with that Article 23 which says - and your Honours will find Article 23 on page 97 which says that:

Income, profits or gains derived by a resident of one of the Contracting States -

for present purposes, a resident of India:

which, under any one or more of Articles 6 to 8, Articles 10 to 20 and Article 22 -

including Article 12:

may be taxed in [Australia], shall . . . be deemed -

to have a source in Australia. So, he joined those two provisions together and then said, I am not going to tax this as a royalty, I am going to tax it as ordinary income - assessable income - less available deductions, under section 6(5) with the deemed source which I have produced by joining together Articles 12 and 23.

Now, that argument was accepted by both the primary judge and by the Full Court but, in our respectful submission, that was an error, it was an error to do so. The error lay in looking only at the context of Article 12 and not looking at the context of the treaty as a whole. That context is the broader structural context which I referred to right at the outset of my oral submissions and that is that the business profits of a non-resident can be taxed in the source country, which here is Australia, but only so much as are attributable to a permanent establishment of the non-resident in Australia. Property income, dividends, interest and royalties, property income arising from personalty, may be taxed in the country in which it arises. "Arises" does not mean has its source, it means from where it is paid.

Now, where property income contributes to business profits, Article 7 does not preclude the property income articles, that is Articles 10 to 12, from applying, but paragraph (4) of Articles 10 to 12 does preclude them if the source of the gross income is effectively connected to the property income. That is because the structure of the treaties is to deal differently with property income from business profits. Now, Articles 10 to 12 are what might be called a "blunt instrument". They tax the gross amounts, not the net gain made by the taxpayer.

GORDON J: But at reduced rates in relation to some of them.

MR SLATER: Yes, I was going to say that, at a flat rate regardless of the profit element but correspondingly at a lower rate than the tax on profits. But, of course, it is a flat rate applied to the gross amount, not to the net amount. That does not matter mostly in the case of property income and it is done that way so that you cannot

escape the tax on interest by having an interest cost offshore. They impose what might be called a "binary" test. Either the condition for the application is satisfied or it is not. If it is satisfied, then the whole amount, not an apportioned amount or a profit element, is taxed, but it is taxed at a flat lower rate.

In contrast, Article 7 is a graduated test. It taxes only so much of the business profits as is attributable to the permanent establishment. It raises questions of partial allocation of source and of partial allocation of both revenue and costs. Similarly, the tests for connection to the permanent establishment in the business profits article and in the property income articles, Articles 10 to 12, are quite different. In the first place, they use different words but they are not the same words. If they had been meant to be the same words - the same content, as the Full Court and the primary judge took, one would have expected them to use the same words. There is no impediment to using the words "attributable to" where the words "effectively connected with" appear in Article 12.

In Article 7 it is a graduated test consistent with the way in which business profits are dealt with. In Article 12 it is a binary test, either it is effectively connected or it is not. In our respectful submission, what the Federal Court did was to confine its attention to Article 12 and not look to the wider context of the treaty as a whole and the structure of the treaties and by doing so, in our respectful submission, they fell into error.

Your Honours, those are the reasons for which we say that the decision below is infected with error or certainly, in our submission, sufficiently open to question to merit reconsideration. I have not dealt yet with the Indian Supreme Court decision, I think I still have time to do that. The result of the Full Court's decision is that there is now a decision of the Full Court of one contracting State to a treaty which is contrary to a decision of the ultimate appellant court of the other party to the same treaty. The essential reasoning of the Full Court can be seen in the judgment, if I can briefly take your Honours - - -

GORDON J: Do you mean the Full Court or the Indian Court?

MR SLATER: The Full Court of the Federal Court, your Honour.

GORDON J: Just before you - are you coming back to the Indian decision?

MR SLATER: I will come back to it in a moment, your Honour. If I could take your Honours to the Full Court decision first, just briefly, and take your Honours to page 69 of the appeal book at paragraph 9. Their Honours were there dealing with the argument at first instance and they note at the beginning of that paragraph that:

The Commissioner argued that Art 12(4) is co-extensive with Art 7(1)(a) -

Then, at the beginning of paragraph 10 at about line 20:

The primary judge accepted the Commissioner's construction.

Then, if I could take your Honours over to page 71 at line 35 in paragraph 20 dealing with the argument for the Commissioner in the Full Court, the Commissioner argued that:

Art 12(4) has a co-extensive operation with Art 7 -

Then, in the next paragraph at about line 45, their Honours said:

the primary judge was correct on the construction and application of Art 12(4).

That is, their Honours said that the primary judge was correct to accept the argument that Article 12(4) and Article 7 were co-extensive. Then at page 75 in paragraph 39, they returned to that as the essence of their reasoning process:

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) -

and I remind your Honours that that is "attributable to", so the reasoning is that the two phrases have the same content. That is contrary to the decision of the appellate bench of the Indian Supreme Court. Now, your Honours, I have to - - -

GAGELER J: Well, it appears to have been one judge.

MR SLATER: Sorry, no, your Honours, it is an appellate bench of two judges of that court.

GAGELER J: I see.

MR SLATER: There are 28 members of that court. It is four times as many as there are on this Court, but they have to deal with one and half billion people, that is about 60 times as many people. In order to get through the workload, they customarily sit as a bench of two on appeals, but it is an appellate bench.

GORDON J: Can I ask two substantive questions about this decision of the Supreme Court of India? The first is do the Japanese notes to Article 7 make a difference?

MR SLATER: In our submission, no, your Honour, but I am not in a position to take your Honour to the notes or to the matter any further.

GORDON J: Well, they are in the judgment.

MR SLATER: Yes. Your Honours, I have an apology to make. I should have provided the judgment to the Court and, by oversight, I failed to do so. Do your Honours have a copy?

GORDON J: We do.

GAGELER J: We do. Whether it is the same print as you have is another matter.

MR SLATER: The print I have is from the Indian Tax Reports, which may not be the same as the print from the Indian Legal Information Institute.

GORDON J: Anyway, that was my first question. And the second is: as is apparent from a cursory glance of it, there was a very different contractual arrangement factually in that case where, as you opened your submissions here, there was in effect an undifferentiated amount to be paid for both the Indian services and the Australian services. In this case there was a clear distinction and allocation of amounts for different types of services. Does that make a difference?

MR SLATER: No, your Honour, because it was not in contest here that the amounts in question were Indian source, and that was the point of the separation in the Indian case. I drew attention to them being undifferentiated because, in our submission, putting aside the Indian decision, the undifferentiation provides the foundation for our saying that they are effectively connected with the Australian permanent establishment, which is the requirement for the exception in Article 12(4).

Your Honours, the Indian decision is very largely concerned with construction of the contract and with construction of the Indian domestic statute. That tends to be the way in which the Indian judgments, if I may respectfully say so, are written. They tend to generally recount the arguments for both sides, recount the prior history, and then at the end set out a series of propositions which amount to their findings and that is what they have done here, so that the findings are actually in about 21 short paragraphs right at the end of the decision.

They are, as Justice Gordon pointed out to me, distinguished between an offshore supply and offshore services, but the steps in the

reasoning clearly include - expressed in paragraph 6 - and their Honours say:

The terms 'effectively connected' and 'attributable to' are to be construed differently even if the offshore services and the permanent establishment were connected.

That is directly the opposite of what the Full Court and the primary judge said here. They have said those terms have the same content.

GORDON J: The reason why I ask this question is because the argument put by the taxpayer in this case was "effectively connected" to the contract, which I thought was an odd way of putting it. So if you go back to the very beginning, they are not looking at "effectively connected" as being effectively connected vis-a-vis attributable to the permanent establishment. The way they seem to argue it, it was effectively connected to the contract but is not attributable to the permanent establishment and I wonder whether that was the reason why ultimately, despite the analysis, one ends up with this finding that they are to be looked at differently.

MR SLATER: I do not think so, your Honour, but without debating it at length, which I do not have time to do, all I can say to your Honour is that, on my reading of it, that is not the way the court reasoned. But, more particularly, what is significant about this is not simply to persuade you of the effect it might have, if your Honours were to grant special leave, but the circumstance that this decision is taken in India as binding for the proposition enunciated in paragraph 6.

So, in India, one has admittedly a briefly expressed decision of a Full Bench of the Indian Supreme Court, which says that the words are to be construed differently. And presently one has, if special leave is refused, a decision of the Full Bench of the Federal Court which, although Justice McHugh and Justice Kirby were more prone to say it than some more recent members of the Court, is effectively the final court of appeal in tax matters in Australia.

So it is a binding decision which would be followed and, if your Honours refuse special leave, would almost inevitably be followed by a Full Bench as well as by other courts - as single members of the Federal Court - to a contrary effect. In our submission, that is an undesirable outcome. It is a matter which merits consideration by this Court. So, if your Honours please, those are our submissions.

GAGELER J: Yes, thank you, Mr Slater.

MR HMELNITSKY: Your Honours, I should say something at the outset about the course of the trial and the way the issues arose.

GORDON J: Mr Hmelnitsky, just one moment, please.

GAGELER J: Yes, give us a moment. Mr Hmelnitsky, are you in a position to address us on this Indian decision?

MR HMELNITSKY: Yes, and I can do that directly.

GAGELER J: It would be helpful if you go straight to that.

MR HMELNITSKY: Yes, I am quite confident I have a different print from the one that your Honours have, but I will try to identify for your Honours the particular references that I want to take the Court to. The first is as to the matter that has already been raised.

The first matter that I would draw attention to is the matter that has already been raised in argument - that is, the existence in the protocol to the Japan-India double tax agreement of additional language that qualifies or affects the meaning of Article 7, the profits article in that treaty. That is language that does not appear in the Australia-India treaty and it is relevantly summarised. It is in the very first part of the judgment. It is in that part of the reasons - - -

GORDON J: We have got a paragraph which commences:

The Treaty contains the Japanese notes -

is that the bit you want:

clause 6 whereof reads as under -

and then it sets out the clause.

MR HMELNITSKY: Yes, and so your Honours will see in clause 6 - I think perhaps I was going to take you to another part of the judgment where much the same language appears. But the point is this and I think your Honours will see it, that the protocol provides that where there is a business connection in India or/and whether all operations of the business are not carried out in India are questions of fact which have to be determined on the facts of each case. And that is the gravamen of it and that was the finding against which the appellate bench came to be dealing with the matter and that is summarised in that very early part of the judgment in numbered paragraph 4 - in that paragraph the chapeau of which is the authority referred to a large number of decisions. So it is set out there what the findings were in relation to the matter, including the effect of that part of the protocol.

Now, the significance of that is that that language which requires an Indian court or, indeed, the contracting parties to that treaty in working out what connection there is between profits and the business enterprise, calls

for an examination on the facts of each case in a way that, arguably, is different from the task that is engaged in our treaty. And one sees that reflected in the relevant finding of the Indian Supreme Court in the paragraph that we have given reference to in our written summary of argument. It is that paragraph that starts:

Since the appellant carries on business in India through a Permanent Establishment, they clearly fall out of the applicability of Article 12(5) of the DTAA and into the ambit of Article 7.

That is the approach to determining - - -

GORDON J: That is the consequence of applying the different language.

MR HMELNITSKY: Yes, and that is the particular approach that we described as idiosyncratic in our written submissions because it does not seem at all to reflect the manner in which that question will be determined under a treaty without that language in the protocol. And that, we say, follows from what appears in the balance of that paragraph, that the protocol to the double tax agreement discusses the involvement of the permanent establishment in transactions et cetera. And then the last sentence there:

The permanent establishment here has had no role to play in the transaction that is sought to be taxed, since the transaction took place abroad.

Now, the question arises in relation to our treaty is the questions that your Honours have seen. They are dealt with in the Full Court. They are whether or not the source of the payment is effectively connected with the permanent establishment, not whether or not they are connected to the contract.

GAGELER J: Yes, thank you, Mr Hmelnitsky.

MR HMELNITSKY: If the Court pleases.

GAGELER J: Mr Slater, do you want to say anything further about that?

MR SLATER: Only, your Honour, that whatever criticisms have been levied at the decision and the distinction that he endeavours to draw, which we would dissent from, there is nonetheless a decision of the full appellate bench of the Indian Court, which is contrary to the view that has been taken in the Full Court here.

GAGELER J: Yes, thank you.

We are not persuaded that there is reason to doubt the correctness of the construction of the treaty adopted at first instance and on appeal in the Federal Court and we are not persuaded that there is, in substance, any conflict between that decision and the decision of the Supreme Court of India, to which reference has been made. In those circumstances, special leave to appeal is refused with costs.

The Court will now adjourn until 10.15 on Tuesday, 28 March in Canberra.

AT 10.59 AM THE MATTER WAS CONCLUDED
