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INSIGHT: India—The Rise of the 'Intangible Business Connection'

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Afaan Arshad and Meyyappan Nagappan, of Nishith Desai Associates, consider a recent ruling where a nonresident entertainer has Indian tax implications even in respect of performances outside India, due to the formation of an "intangible business connection" in India.

In the case of Volkswagen Finance Pvt. Ltd v Income Tax Officer, the Mumbai bench of the Income Tax Appellate Tribunal Mumbai (Tribunal) held that payment made by an Indian entity—Volkswagen Finance Pvt. Ltd (Appellant)—to Nicolas Cage for making an appearance in a product launch event held in Dubai, that was intended to target the Indian market, was taxable in India due to the formation of an "intangible business connection" in India.

In accordance with this revolutionary concept, the Appellant was held liable to deduct taxes on the payments made to Nicolas Cage, under Section 195 of the (Indian) Income Tax Act (Act). This concept, if confirmed by appellate courts, holds the potential to turn current international tax and Indian constitutional law on its head with wide ramifications for companies and individuals around the world where any income derived from an activity that targets the Indian market will be sought to be taxed by India.

Background

The Appellant and Audi India, both Indian companies and part of the Volkswagen group (together referred to as "Organizers") had organized an event in Dubai for the launch of brand Audi's new model Audi A8L Facelift (Audi A8L) for the Indian market in May 2014 (Event).

For the purpose of the Event, the Organizers had commissioned a company in the U.S. for facilitating the appearance of Nicholas Cage, a Hollywood Oscar winning international celebrity (Celebrity) for three consecutive hours.

As part of the appearance, the Celebrity was to be driven in the new Audi A8L model into the venue, engage with Audi India in a Q&A session and socialize with the guests. In part consideration for this appearance, the Appellant paid $440,000 plus incidental costs ("Appearance Fee"), which formed the subject matter of the tax dispute in this case. The Organizers had also flown in 150 guests from India comprising of prospective buyers (Indian socialites and social influencers likely to influence other prospective buyers of the Audi A8L in India) and journalists for the Event.

As part of the arrangement with the Celebrity, the Organizers had full right to use footage/material/film/stills/interview of the Event capturing the Celebrity's presence across all platforms for "below the line publicity on the internet, in press releases, news reports, social media, Audi Magazine, etc. for a period of 6 months from the date of the launch event, and for an unlimited period of time only for internal usage with the Volkswagen group."

During scrutiny by the tax department, the Appellant had claimed that since the Celebrity's appearance took place in Dubai without the carrying out of any activities in India, the Appearance Fee could not be treated as having arisen or deemed to have arisen in India and hence was not taxable in India.

Accordingly, the Appellant was under no obligation to deduct any taxes on the payment of the Appearance Fee. Unimpressed by these claims, the tax officer or assessing officer (AO) held that the Appearance Fee was taxable as a "royalty" under Section 9(1)(vi) of the Act.

The AO also held that the Appellant had no relief in this regard under the provisions of Article 12 (which deals with royalty) of the India–U.S. double taxation avoidance agreement (U.S. Treaty). Upon appeal, the CIT (Appeals) not only confirmed the action of the AO, but also proceeded to hold that the whole purpose of organizing an India-centric event in Dubai was to avoid attraction of the clause that deemed income to accrue or arise in India and therefore to escape taxation in India.

Ruling

As per Section 5(2)(b) of the Act, a nonresident is taxable in India if income accrues/arises or deemed to accrue or arise in India. A simple reading of the provision indicates that an event resulting in accrual of income in India must take place in India, which did not happen in the present case. However, given the broader scheme of the Act, Section 5(2)(b) needs to be read with Section 9(1)(i) of the Act which extends the scope of income accruing or arising in India by way of a deeming fiction to, inter alia, income accruing or arising in India, whether directly or indirectly, through or from any "business connection" in India.

While discussing the significance of "business connection," the Tribunal referred to the commentary on the Act by Kanga and Palkhivala (Kanga and Palkhivala, The Law and Practice of Income Tax, 7th ed., p. 200) which states that "the categories of business connection are incapable of exhaustive enumeration."

Further, the Tribunal noted that, the definition of "business connection" as set out in Explanation 2 to Section 9(1)(i) of the Act is only an inclusive, and not exhaustive definition. Lastly, the Tribunal referred to the Supreme Court decision of CIT v. RD Agarwal & Co wherein, in the context of "business connection," it was observed that "important cases which have arisen before the courts may briefly be reviewed, not for evolving a definition applicable generally to all cases but with a view to illustrate what relations between the non-resident and activity in the taxable territories which contributed to the earnings of the income may or may not be regarded as business connections."

Such references by the Tribunal indicated that it believed that the test of "business connection" is an ever-evolving and dynamic one based on the prevailing realities of business and should not be restricted to existing definitions and judicial precedents. While indicating so, the Tribunal also rejected the Appellants' claim that based on judicial precedents, "business connection" should be formed in India only when economic activity is actually carried out in India.

The Tribunal held that, in the present case, the income earned by the Celebrity had arisen through a "business connection" in India for the following reasons:

- the recording of the Event which contained the Celebrity appearance was used for—"below the line publicity on internet, in press release, news reports, social media" i.e. advertisement and marketing to a specific group of potential customers via online platforms—for the benefit of and furthering the business interests in India of the Organizers;
- the Event was an India-centric event and the entire expenses for it were borne by the Organizers. The said expenses were also claimed by the Organizers under Section 37(1) of the Act thereby implying that they were incurred "wholly and exclusively for the purposes of business" of the Organizers who only had business in India;
- considering the costs incurred in organizing the Event and the social status of the guests (who were likely to influence prospective buyers in India), it could not be said that the Event was organized only for the 150 guests that were flown in;
- the target audience, potential customers and intended benefits were in India. The Tribunal also relied on a note submitted by the Appellant describing the Event wherein it was stated that the Appellant is a captive finance company within the Volkswagen group and the Event, by way of generating inquiries of potential Indian customers followed by potentially the need for them to obtain finance from the Appellant, was designed to benefit the Appellant, among other things.

For all these reasons, the Tribunal concluded that there was a relationship between the Event in Dubai and the business of the Appellant in India, and it is this relationship that resulted in the formation of the "business connection" in India.

While rendering its ruling, the Tribunal also rejected the Appellant's claim that since the case of the AO was confined to taxability of the Appearance Fee as "royalty," the Tribunal should not go beyond the contours of examining the question of "royalty."

In this regard, the Tribunal while relying on Jeypore Timber & Veneer Mills (P.) Ltd v CIT and Tata Communications Ltd v JCIT (which followed the Supreme Court's decision in Hukumchand Mills Ltd. v CIT) observed that it has wide powers while adjudicating an appeal and is not restricted by the grounds raised by either side in the appeal. Separately and for the sake of argument, the Tribunal also noted that the grounds raised by the Appellant itself had a question on "business connection," and the Appellant's claim in this regard was therefore not sustainable.

The Tribunal also rejected the argument of the Appellant that—since the Appearance Fee did not fall within the ambit of Section 115BBA of the Act, which specifically deals with taxation of nonresident entertainers—on the basis that existence of a special provision cannot be considered as restriction on chargeability generally under Section 5(2)(b), and if an income does not fall under a specified provision, it may very well be taxable under the general provisions of the Act.

Lastly, the Tribunal rejected the claim of the Appellant that since the Appearance Fee was not covered under any specific Article in the U.S. Treaty, it constituted "other income" under Article 23, as per clause (1) of which, income shall be taxable only in the state of residence of the income earner, which in this case was the U.S. The Tribunal rejected this claim for the simple reason that clause (2) of Article 23 of the U.S. Treaty, which is a non-obstante clause, provides that the income may also be taxed in the source state, which in this case was India.

Comments

The judicial overreach by the Tribunal in this ruling is apparent. The Tribunal has disregarded the scope of Section 9(1)(i) read with Section 5(2)(b) as interpreted by higher judicial authorities and assumed the role of lawmakers. The ruling is likely to go down in history as one of those that contributed towards expanding the scope of "business connection" from covering "doing business in India" to going beyond even "doing business with India" to a very expansive "targeting Indian market" or "targeting Indian customers."

This appears to be a clear fallout of similar arguments being used by the Indian government in discussions with the Organization for Economic Co-operation and Development (OECD), highlighting the importance of the market or the customers in the market jurisdiction in taxation and allocation of income derived by offshore digital companies.

In the post-BEPS world, the arguments used by the Indian government appear to have colored the judgment of the court in this case and appear to supply part of the missing jurisprudence underpinning the recent expansion of the equalization levy.

To quickly recap, India has been proactive in devising tax rules for nonresidents doing business in India through digital means. Through the Finance Act, 2018, the government had expanded the scope of "business connection" under the Act by introducing the concept of significant economic presence (SEP) which provides that nonresidents providing digital goods and services to Indian recipients or soliciting business in India through digital means should constitute a "business connection" subject to satisfaction of objective conditions.

Interestingly, Finance Act, 2020 expanded the concept and postponed the applicability of SEP to April 1, 2021 in light of evolving global discussions on the subject of taxation of digital economy, hoping for consensus by next year. However, it introduced and expanded the equalization levy imposing a 2% turnover tax on online advertising services between two foreign parties if it involved targeting of customers resident in India.

The ruling at hand seems to be an example of the judiciary prematurely infusing existing law with the spirit of the above provisions, that too without the objective thresholds which would have demarcated the boundaries of the SEP concept. This indicates that not only has the judgment gone beyond existing judicial precedents, but also the intention and legislative power of the legislature.

It also appears that in its attempt at judicial activism, the Tribunal lost track of the core issue pertaining to the case. Ideally, the case should have been about whether the Celebrity, a nonresident who made an appearance outside India, constituted a "business connection." However, the Tribunal seems to have instead analyzed whether the Event had a "business connection," based on the relationship between the Event and the Indian entities that organized it, focusing on how the Event was targeting the Indian market.

Planning Points

Under the current provisions of the law (both the Act and most tax treaties), the minimum requirement for nonresident entertainers to be taxed in India is for their performance to be in India. Based on this ruling, entertainers have to be wary of Indian tax implications even in respect of performances outside India, so long as the target audience is based in India. Starting from World Cup cricket and football matches to actors who are acting in a movie or television series with an Indian market, the tax exposure through this ruling could be unlimited.

Similarly, production houses/digital content provider companies would have to now evaluate withholding tax implications in respect of payments to be made to nonresident entertainers for performances outside India, so long as the target audience may be based in India. This is because even in the case at hand the material recorded at the event could be used for the Indian market within six months of the event. Therefore, the recorded material targeting the Indian market was sufficient according to the case to create a taxable presence.

While in this ruling the entire target audience was in India, given the aggressive nature of the tax department and the changing attitude of the judiciary, payments made to nonresident entertainers for performances outside may be considered to have withholding tax implications upon formation of a "business connection" in India even if part of the target audience is based in India. Further, unlike some of the scenarios set out below, treaty benefits may not be sufficient to mitigate any tax risks.

Advertising agencies that create advertisements outside of India to nonresidents, that target the Indian market may be caught within the Indian tax net even if they produce content or conduct advertising events outside India.

Any person earning income from a conference or marketing event outside India that targets the Indian market could also be covered. In a similar vein, the list of taxpayers potentially impacted could be a large one.

Finally, as per the nexus theory enshrined in the Constitution of India and endorsed by the Hon'ble Supreme Court, India can only tax foreign income which has a substantial territorial nexus with India. In other words, the foreign income should have a real and substantial connection and not an illusory one with India. Otherwise, the law is liable to be unconstitutional if the requirement for nexus is not met.

In the present case, the activities of the Celebrity did not have any impact in India as they occurred outside of India. If it is understood to have indirect effect, then there are no principles today to determine when such impact shall be considered remote enough to not create a taxable presence.

Further, the footage of the event being used is separate from the activities carried out at the Event and should not be considered as having had any direct impact in India. Further, the sharing of the footage online for marketing purposes was an act independent and unconnected to the act of participating in the event outside India by the Celebrity. Accordingly, owing to lack of real and substantial nexus of the income with India, this ruling appears to have in effect interpreted the law so widely that it could be struck down as unconstitutional, similar to the newly-expanded version of the equalization levy, which seeks to tax payments made by nonresidents to nonresidents, so long as the targets are the consumers in India.

Nevertheless, while it is hoped that the appellate courts should settle this controversy the right way, clients should prepare themselves for such increasingly expansive rulings and new wider taxes in the future. This trend, as can be seen in this case, is not merely restricted to digital taxes and is likely to lead to double taxation resulting in a chilling effect on cross-border trade.

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