S.No	Issue for Consideration	AAR observations/Verbatim
1	Connotation of phrase ***"effectively connected"*** vis a vis taxation of Royalty on "NET" basis (in place of GROSS basis) with Permanent Establishment (PE) already in place, under Article 12 of Double Taxation Avoidance Agreement (DTAA)	*"11. The rationale of Art.XII(4) seems to be to tax the non-resident on the same basis as a resident of the source country i.e., on net income basis in so far as he derives profits on account of operations carried out through a fixed base or establishment maintained by him in the source country. However, the pre-requisite for attracting the exclusion clause is that "the services in respect of which the royalties are paid are effectively connected with the permanent establishment". It must be noted that the effective connection should be between the royalty generating services and the permanent establishment. The expression 'services' is significant and should be given due weight. It is not enough that there is a permanent establishment of the non-resident in the source country carrying out some activities in connection with the project or the work. The PE may be effectively connected with the project and the contract from a broader perspective but the connection contemplated by Para 4 of Art.XII is in respect of the services that fall within the purview of royalty. The PE or fixed base set up in the source country should be engaged in the performance of royalty generating services, irrespective of what other activities it performs. Atleast, it should facilitate the performance of such services. The terminology 'effective connection' denotes a real and intimate connection. Clear co-relation between the services which give rise to royalty income and the PE is a key factor for the purpose of exclusion of paragraphs 1 & 2 of Art.XII. Prof. Klaus Vogel in his commentary on the provisions of Model Convention stated thus in the chapter dealing with "permanent establishment proviso": "As the English and French texts of MC reveal, the term 'effectively connected with....' ('s'y rattache effectivement') should not be understood to mean the opposite of 'legally connected', but rather something in the sense of 'really connected'. Consequently, what has to be examined is*

		whether the claim is connected with the permanent establishment not only in form, but also in substance." *Performing and providing services from Australia under the Business Enginerring & Procurement Agreement cannot, without anything more, give rise to effective connection with the PE in India.* ***We reiterate that the effective connection contemplated by Art. XII(4) must be between the services giving rise to royalty and the PE****. That there is overall connection of such services to the project and the fact that such services are essential for the execution of the project is a different aspect* ***A real and perceptible connection should exist to fulfil the said criterion***
2	Applicability of Supreme Court ruling in Ishikawajima to instant ruling vis a vis "Effectively connected" issue is concerned	***"The observation of their Lordships though contained in one sentence would imply that there may be situations in which the services etc. have an effective connection with the PE, still attribution in terms of Art. 7.1 may not be possible***. Such an attribution could only be in accordance with what has been laid down in the Protocol to the DTAA. In this context, it is important to note that there is no categorical finding or observation of the Supreme Court anywhere in that case that the offshore services were effectively connected to the PE in India. On the other hand, the learned Judges guardedly added a rider while formulating propositions 2 and 6 to the following effect : "assuming the offshore elements form an integral part of the contract" and more importantly – "even if the offshore services and the permanent establishment were connected." ***We are of the humble opinion that the discussion proceeded on the basis that by reason of the exclusion clause contained in Article 12.5 of Indo-Japan Treaty, the clause dealing with business income i.e., Art.7 would apply and by applying the said Article, only that portion of the income arising from the operations of PE can be taxed in India. No specific finding was recorded by their Lordships***

		on the point of 'effective connection', but the learned judges discussed the issue on the assumption that the exclusion clause applies and as a sequel to that Article 7 would come into play. Moreover, from what is stated at p.441, the Supreme Court cannot be said to have laid down a proposition that the mere existence of PE is enough to trigger the exclusion clause in Art.12.5 so as to make room to Art.7" There is one more aspect which will have some relevance in understanding the observations referred to supra. In the DTAA between India and Japan, the terminology of Art.12 is somewhat different. The phraseology used in Art.12.5 is "the right, property or contract in which the royalties or fees for technical services are paid is effectively connected with the PE". In such a case, Art.7 will apply. Instead of the word 'services' occurring in the Treaty with which we are concerned, the expression 'contract' is used therein. ***In view of this language of Art.12 (5), a view can be taken that the contract as a whole was effectively connected with the PE though the particular services (offshore services) were not so connected. Apparently, for this reason, their Lordships have proceeded on the premise that the offshore services forming part of the contract though rendered outside India were effectively connected to the PE, though the PE had no role in playing the actual rendering of such services.*** ***As discussed earlier, Article VII comes into the picture only when the exclusion clause in XII.4 comes into play. To attract XII(4) there must be effective connection between the services giving rise to royalty income and the PE in India. In the case of Ishikawajima, it was not found as a matter of fact that the offshore services were effectively connected with the PE. On the other hand, the observation in the above extracted passage and elsewhere would show that the non-resident's PE in India had nothing to do with the offshore services***. Then, why their Lordships have expressly stated

		that "article 7 is applicable in this case"? It seems to us that this proposition should be read along with the preceding two propositions No. 7 & 6. In proposition No.7 the application of section 9(1)(vii)(c) was ruled out by interpreting that provision in a ***particular manner. That means, the income cannot be treated as FTS under the Act. It would then be business income having regard to the well established rule that if a matter is governed by the DTAA as well as statutory provision, whichever is more beneficial to the assessee, could be invoked, Art. 7 of DTAA could be invoked by the non-resident assessee as it turned out to be beneficial to him. Secondly, as discussed earlier, effective connection was assumed by their Lordships in paragraph 6 without expressing any opinion whether in fact such connection was there***."
3	Applicability of SC ruling in Ishikawajima vis a vis Territorial Nexus issue – SC ruling Doubted and Respected by AAR	"..On a reading of the above passage, two things are not clear: First, why reference has been made to sub-clause (c) of Section 9(1)(vii) instead of sub-clause (b) which is couched in a different language and deals with a different situation? The relevant portion in sub-clause (b) that covered the case of the appellant - Ishikawajima is the "income by way of fees for technical services payable by a person who is a resident." In sub-clause (b), there is no mention at all of the services being utilized, much less rendered, in India. Secondly, why their Lordships stated that sub-clause (c) of Section 9(1)(vii) specifically* requires two conditions to be met, namely, that "the services which are the source of income that is to be taxed has to be rendered as well as utilized in India" in order to be taxable in India? The expression 'rendered', perhaps used in the sense of 'performed' is not to be found even in the inapplicable clause (c). ***Though it is difficult to find an answer, we cannot ignore the dicta in the above passage. We have to respect the observations of the Supreme Court and the spirit behind it, without invoking the doctrine of per incuriam as far as possible.. The overall impression we get, especially after reading some of the subsequent***

		paragraphs, is that their Lordships wanted to interpret Section 9(1)(vii) in harmony with territorial nexus principle. Hence, the requirement of rendering the services in India was read into the said provision, though specifically that requirement is not to be found in that clause. A reference to certain other passages would perhaps throw better light in understanding the implications of the dicta laid down in Ishikawajima case. At page 443, it was observed: ***Observations in Ishikawajima on legal fiction and source of income*** ***17.7 The Supreme Court observed at page 430 that "having regard to the contextual interpretation", the legal fiction created by S.9 should be construed having regard to the object which it seeks to achieve. However, it is not indicated as to what is the object of the said provision that deters the legal fiction being carried to the extent specifically provided by the language of the Section. The object of section 9(1) is to deem certain incomes as income accruing or arising in India so as to widen the net of taxation in respect of the resident's and non-resident's income by dispelling doubts and controversies as to the situs of accrual of income. In fact, in the various treaties entered into with different countries, the power of taxation of the State wherein royalties arise is recognized. Thus, the object of Section 9 will in no way be defeated if the legal fiction enacted by Section 9, is taken to its logical extent.*** 17.9 On the point of territorial nexus there is one more observation of the Supreme Court which needs to be explained. Under the same heading "offshore services" - proposition no.10 (at page 447) says : "the location of the source of income within India would not render sufficient nexus to tax the income from that source."

		In our humble view, the said observation cannot be construed to mean that the age-old test of source of income should be eschewed altogether while considering territorial nexus. At best, the quoted statement may mean that the source test is not always decisive. That the Supreme Court found the source test as a relevant factor in the earlier part of discussion deserves mention in this context. It was categorically observed at page 434: "even there is nothing to prevent the income accruing or arising at the sources". Not only that, the dicta of Kania C.J. in CIT vs. Ahmed Bhai* was approvingly referred to in the same page (434). The learned Chief Justice emphatically stated : "I am however unable to accept the contention that the source of income can never be the place where the income accrues or arises". 18. A doubt still lingers in one's mind as to why the Supreme Court proceeded on the basis that the offshore services performed by the contractor executing a turnkey project as a step-in-aid to the execution of the project and deploying those services in India had no real connection to the Indian territory? Do they not give rise to a 'live link'* with the Indian territory? Why their Lordship felt that the income arising therefrom did not accrue or arise in India, not to speak of deemed accrual? ***One would not find a direct answer on a perusal of the judgment of the Supreme Court because the nuances of territorial nexus principle were not the subject-matter of discussion. At the same time, we are by duty bound to give effect to the law - be it the ratio decidendi of the judgment or the obiter dicta of the Supreme Court. But, we must bear in mind the apt and instructive words of the Supreme Court spelling out the approach to be adopted and the caution to be observed in appreciating the law declared by a decision of the Supreme Court. In the case of CIT vs. Sun Engineering Works Ltd.^ , the principle was succinctly stated thus: "The judgment must be read as a whole and the observations from the judgment have to be considered in the light of the questions which were before this court. A decision of this court takes its colour from the questions involved in the case in which it was***

		rendered and, while applying the decision to a later case, the courts must carefully try to ascertain the true principle laid down by the decision of this court and not to pick out words and sentences from the judgment, divorced from the context of the questions under consideration by this court, to support their reasonings". ***20. As stated earlier, this Authority has to give full effect to the law laid down and the observations made by the Supreme Court vis-à-vis territorial nexus in the context of Section 9(1)(vii) (similar to Section 9(1)(vi)). There is no doubt that the facts of the present case should be tested in the light of the ratio underlying the decision of Supreme Court in Ishikawajima. Even then, we are unable to hold that the territorial nexus is lacking in the present case just as in the case of Ishikawajima***. This is not a case where the entirety of offshore services were performed in a foreign country which was the base of the contractor. Even on the showing of the applicant, about 20% of the services were performed in India.
4	Views on Project Management Services	Project Management Services 21. Then, we turn our attention to the Project Management Services (PMS) covered by the Second Agreement. We have already referred to the main provisions therein. The case of the applicant that by the date of closure of the contract, certain project management services were performed in India through the PE has to be accepted. ***The nature of the services coupled with the calculation of amount payable to the applicant based on estimated man days 'at Mumbai' would lead to the conclusion that these services would not have been performed from Perth only. The presence of the applicant's personnel for considerable number of days appears to be necessary to discharge the responsibilities cast on the applicant under this Agreement. The P.M. services had apparently commenced after the basic engineering phase was over and the basic designs, drawings and***

		procurement plans were made ready. It was at that stage i.e. in the month of October, 2001 that the PE was set up in Mumbai and the applicant's management and technical personnel stayed in Mumbai for days together and worked from the office of the local engineering contractor, namely, Jacobs Engineering Co. The estimated completion date for the project management related services was 30th November, 2002, as seen from Art.V of the Agreement. Keeping all these factors in view, we have no hesitation in holding that the P.M. services were effectively connected with the PE located in Mumbai and the receipts therefrom (which according to the applicant is 899,189 Aust. Dollars) shall be treated as business income and be taxable only to the extent they are attributable to the operations of PE in India.

SC observations in Eli Lily as noted in aforesaid Advance Ruling:

"In the latest decision in CIT, New Delhi vs. M/s. Eli Lilly and Company (India) Pvt. Ltd#. the Supreme Court discussed the nature and scope of section 9. S.H. Kapadia , J observed thus:
"a general charge of income-tax is imposed by Section 4 and 5, and that general charge is given a particular application in respect of non-residents by Section 9 which enlarges the ambit of taxation by deeming income to arise in India in certain circumstances."

Earlier it was observed: "Section 9 which deems certain categories/heads of income to accrue in India has no application in cases where income actually accrues in India. Likewise, Section 9 does not apply in cases where income is received in India. Therefore, if the income is not received in India, a non-resident would not be chargeable to tax upon it unless it accrues or is deemed to accrue in India".

Section 9 was described to be a combination of machinery provision as well as charging provision."