

THE CHANGING FACE OF SERVICE PERMANENT ESTABLISHMENTS

Authors

Neha Rastogi
Stanley C. Ruchelman

Tags

India
Permanent Establishment
Physical Presence
Place of Performance

INTRODUCTION

Broadly speaking, a Service permanent establishment (“P.E.”) is an international tax concept under which services provided by a nonresident may give rise to a P.E. in the source country if the services are provided beyond a certain period of time. The concept was first inserted in the U.N. Model Tax Convention in 1980, and while tax authorities across the world remain split on whether a Service P.E. requires a fixed place of business in the source country, the Indian tax authorities recently introduced a new dimension that is further baffling the tax world.

IS “PHYSICAL PRESENCE OF EMPLOYEES” NO LONGER A PRECONDITION FOR IMPOSING TAX?

India Holds Physical Presence of Employees Not Required

Recently, an Indian Income Tax Appellate Tribunal¹ (the “Tribunal”) presided over a matter² that addressed whether a Service P.E. existed in India with regard to a business carried on by a U.A.E. L.L.C., ABB FZ.

ABB FZ was engaged in the business of providing regional services to a related party in India. The employees of the L.L.C. were present in India for 25 days, during which services were provided. However, the employees continued to render services on a regular basis from the U.A.E. through emails, video conferencing, and other electronic modes for more than nine months within a 12-month period.³

The Tribunal determined that ABB FZ had a Service P.E. in the facts presented and held that the presence of employees is not required in the source country for a Service P.E. to exist. The Tribunal emphasized that it is not the presence of the employees that is important. Rather, it is the furnishing of services for more than the specified period of time (regardless of the place of performance) that determines whether the nonresident employer has a Service P.E. in India. Needless to say, this

¹ An Income Tax Appellate Tribunal is the first judicial appellate authority for trying direct tax matters in India.

² *ABB FZ-LLC v. Deputy Commr. of Income tax (International Taxation)*, [2017] 83 taxmann.com 86.

³ Article 5(2)(i) of the India-U.A.E. tax treaty provides that a non-resident has a Service P.E. in the source country if it furnishes services through its employees in the source country and such services continue for a period of more than nine months in a 12-month period.

approach has shocked tax advisers even more than the decision in the *Formula One* case.⁴

The Tribunal held that in the present age of technology, where the services, information, consultancy, management, etc. can be provided through various virtual modes (e.g., email, internet, video conference, remote monitoring, remote access to desktop), the physical presence of the foreign taxpayer's employees is not relevant for determining the existence of a Service P.E. in the source country.⁵

If the Tribunal's decision is upheld on appeal, almost all income earned by a non-resident from providing services to an Indian affiliate from a base outside India will be taxed in India under the Service P.E. concept as applied. All that is required is for the services to be rendered for more than a specified period of time. Where the Indian company reports to a foreign parent, services likely would be provided through e-mails, teleconferences, and video feed on each working day during the year. Therefore, it is likely that the Indian tax authorities will argue for the existence of a Service P.E.

It may be noted that under Indian domestic tax law, fees for technical services provided by a nonresident are taxed in India regardless of whether the nonresident has a place of business in India or the services are rendered in India.⁶ It appears that the Tribunal borrowed the logic from that provision and applied it to the requirements of the Service P.E. clause under the India-U.A.E. Tax Treaty. It is noteworthy because there is no "Fees for Technical Service" clause in the treaty, and in the absence of a P.E. in India, the fee would have completely escaped Indian taxation.⁷ Thus, it appears that the Tribunal underwent such creative thinking in an attempt to tax the service income in India.

The decision of the Tribunal implies that the place of performance of services is not relevant for determining the source of income. Rather it is the place of final consumption/utilization of such service that determines its source. Instead of an income tax, which compensates a service provider for its actions performed at the location where employees are based, the activity is subject to consumption tax, which is based on the place of consumption. Recent E.U. proposals to tax the income of U.S.-based digital companies, such as Amazon and Google, reflect a similar approach.

"The physical presence of the foreign taxpayer's employees is not relevant for determining the existence of a Service P.E. in the source country."

⁴ *Formula One World Championship Ltd. v. Commr. of Income-tax*, (IT)-3, Delhi, [2017] 80 taxmann.com 347 (SC); judgement dated April 24, 2017. In the case, a U.K. resident licensed the use of certain intangible property to an Indian company that operated a Formula One grand prix race in India. The U.K. resident received a fixed fee of \$40 million. The build-up for the race and the race itself took place over a limited period of time using a track facility owned by a third person. Affiliates of the U.K. resident exercised media and title sponsorship rights in India. In broad terms, the limited period leading up to the race represented the entire period during which business was conducted in India. The Indian Supreme Court held that the U.K. resident maintained a P.E. in India and the license fee paid to the U.K. resident was fully taxable.

⁵ The Tribunal, however, held that this issue will only have any bearing on the issues under considerations if on examination of facts it is concluded that the activities of the taxpayer do not fall under any of the articles of the tax treaty.

⁶ Explanation after section 9(2) of the Income-Tax Act, 1961.

⁷ The Tribunal, however, ultimately held that consideration for services is in the nature of Royalties under the India-U.A.E. Tax Treaty.

The rationale behind the Tribunal's decision appears to be contrary to the concept of tax neutrality between a sale of goods and provision of services. Profits arising from a transaction that involves a simple sale of goods from a nonresident is not taxable in the source country in the absence of a P.E. of such nonresident seller. By similar reasoning, services performed outside India for an Indian resident should also be free of tax in India, if only to preserve similar treatment for sales and services.

U.N. Maintains Traditional Approach but Concedes to Minority

Although the existence of a Service P.E. without the physical presence of employees in the source country is an enormous deviation from generally accepted international tax standards, it is not totally unheard of.

In its 10th and 11th sessions, in 2014 and 2015 respectively, the U.N. Committee of Experts on International Cooperation in Tax Matters (the "U.N. Committee") agreed that the traditional interpretation of the Service P.E. requires the physical presence in the source country of individuals, being employees or personnel of the nonresident furnishing services in order for a P.E. to exist in source country. However, a minority emphasized the term "furnishing" as used under Article 5(3)(b) of the U.N. Model tax Convention and contended that the furnishing of services does not require a physical presence. As the term furnished suggests the place where the customer benefits from the service, physical presence of employees in the country of consumption becomes irrelevant as long services are furnished for more than 183 days (*i.e.*, the threshold specified under Article 5(3)(b) of the U.N. Model Tax Convention).

The U.N. Committee acknowledged that the growth of technology has made it possible to furnish services without any physical presence in the source country and, for that reason, did not reject outright the minority view. Rather, the U.N. Committee required countries adopting the minority view to seek agreement through a mutual agreement procedure under Article 25 (Mutual Agreement Procedure) when the treaty partner followed the majority view of physical presence.

In 2016, Saudi Arabia adopted the minority view and formally implemented guidelines to recognize the existence of a Service P.E. without the presence of employees in Saudi Arabia. Under the Saudi guidelines, a nonresident is deemed to have a Service P.E. in Saudi Arabia if

- it furnishes services to a person in connection with the latter's activity in Saudi Arabia, and
- under the contract, the duration of services rendered exceeds the threshold period under the applicable tax treaty (predominantly a 183-day limit).

In effect, Saudi Arabia does not require the physical presence of employees to establish a Service P.E. with respect to the provision of cross-border services. The validity of such internal guidelines may be questionable in a treaty context, since they reflect a unilateral interpretation of that tax treaty whereas the provisions of the entire treaty represent the benefit of a bargain.

WHAT WOULD HAPPEN IF *ABB FZ* WAS TRIED IN THE U.S.?

The Service P.E. concept, which was conceived by the U.N. Model Tax Convention, has also appeared in U.S. tax treaties with Canada and certain developing countries. Thus, it is interesting to examine how U.S. courts may rule on a transaction like the one in the *ABB FZ* case, where services are provided in a foreign jurisdiction and consumed in the country.

Under current U.S. domestic law, it is likely that U.S. courts would emphasize the place of performance of services instead of the place of consumption to determine the source of income.

In a landmark case, *Piedras Negras Broadcasting Co. v. Commr.*,⁸ the U.S. Court of Appeals for the Fifth Circuit addressed the source of income arising from the sale of radio time and the dissemination of advertisements by a radio station located in Mexico. Despite the fact that 90% of the station's listener response came from U.S. and 95% of its income came from U.S. advertisers, the court held that a nonresident is not considered to have performed services in the U.S. without some physical presence in the U.S. and made the following observations:

We think the language of the statutes clearly demonstrates the intentment of Congress that the source of income is the situs of the income-producing service. The repeated use of the words within and without the United States denotes a concept of some physical presence, some tangible and visible activity. If income is produced by the transmission of electromagnetic waves that cover a radius of several thousand miles, free of control or regulation by the sender from the moment of generation, the source of that income is the act of transmission.

All of the respondent's broadcasting facilities were situated without the United States, and all of the services it rendered in connection with its business were performed in Mexico. None of its income was derived from sources within the United States.

The Court of Appeals emphasized the situs (*i.e.*, the place of performance) of the services to determine the source of income. For services provided via e-mail, video conferencing, or other digital medium, it may be argued that the source of income arising from that service is its situs (*i.e.*, the place of performance). If other U.S. courts follow the rationale of the Court of Appeals, then it is likely that services provided electronically from outside the U.S. would not be taxed in the U.S.

In any event, this is the current state of U.S. domestic law. Since an income tax treaty generally cannot increase tax, a treaty resident presumably always maintains the right to elect to apply U.S. domestic law instead of a treaty. However, since the I.R.S. generally does not permit "cherry picking" of provisions, the treaty resident must choose between applying the treaty in its entirety or not at all.



⁸ 127 F.2d 260.

DOES A SERVICE P.E. REQUIRE A FIXED PLACE OF BUSINESS?

Proving that ABB FZ had a fixed place of business in India seemed to be the least of the Tribunal's concerns since it was already of the view that ABB FZ had a Service P.E. by reason of providing services to a party inside India beyond the specified period of time. Nonetheless, the Tribunal observed that Article 5(2) of the India-U.A.E. tax treaty, which, inter-alia, includes the concept of Service P.E., broadens the scope of Article 5(1), which defines P.E. as a fixed place of business in the source country. Therefore, Article 5(2) was not a prerequisite to fulfilling the requirement of Article 5(1), as Article 5(2) is independent of Article 5(1) and the condition of fixed place of business is not attached.

The Johannesburg Tax Court reached a similar conclusion, albeit along a different path, in a case⁹ that addressed a matter involving a U.S. service provider. While, the Tax Court held that the two comparable subparagraphs of the U.S.-South Africa tax treaty cannot be read disjunctively or treated separately, it nonetheless held that a Service P.E. does not require a fixed place of business in the source country.

In the Johannesburg case, the employees of the U.S. taxpayer visited South Africa to provide consulting services to South African airlines, and the days of presence in South Africa exceeded 183 days in a 12-month period. Article 5(2)(k) of the U.S.-South Africa tax treaty provides that employees must be present in the source country for more than 183 days in any 12-month period for the nonresident employer to have a Service P.E.:

The term 'permanent establishment' includes especially: * * * (k) the furnishing of services, including consultancy services, within a Contracting State by an enterprise through employees or other personnel engaged by the enterprise for such purposes, but only if activities of that nature continue (for the same or a connected project) within that State for a period or periods aggregating more than 183 days in any twelve-month period commencing or ending in the taxable year concerned. (emphasis added)

The issue in this case was whether, once the requirements of Article 5(2)(k) are met, the U.S. service provider must also have a fixed place of business in South Africa for it to have a Service P.E.

The Johannesburg Tax Court emphasized the phrase "includes especially" appended to Article 5(2), and observed that, by using this phrase, the drafters of the treaty intended that the factors referred to in Article 5(2)(k) be made part of the definition referred to in Article 5(1); otherwise, they would not have used the words "includes especially." The Tax Court, therefore held that the contents of Article 5(2)(k) must be read as an integral part of Article 5(1).

Based on this analysis, an enterprise becomes liable for taxation in the nonresident country as soon as its activities fall within the ambit of Article 5(2)(k). There is no need to examine whether a fixed place of business exists under Article 5(1). The definition is composite by virtue of the bridging phrase "includes especially." To

⁹ *AB LLC and BD Holdings LLC v. Commr. SARS*, (13276) [2015] ZATC 2.

break it up and treat the two articles separately would be to ignore the natural and ordinary meaning of the phrase.

CONCLUSION

The Service P.E. clause was first inserted in the U.N. Model Tax Convention in 1980, when electronic commerce was unheard of. It is therefore understandable that the drafters did not intend to impose tax on services provided with no physical presence in the source country. However, with advances in technology, the concept of a fixed base seems to be out of touch with today's business practices. Jurisdictions such as India, Saudi Arabia, and South Africa are changing the face of the old provision. Soon it may no longer be recognizable.

“With advances in technology, the concept of a fixed base seems to be out of touch with today's business practices.”