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Service PE—A New Era of Litigation

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In a recent case the Bangalore Tribunal has analyzed the concept of a service permanent establishment; its analysis is unique and its interpretation may now lead to further litigation.

The concept of permanent establishment ("PE") holds vital importance as far as international taxation is concerned. The existence or otherwise of a PE of a foreign enterprise ("FE") in the source state is a key determinant for its business taxability in the source state. The existence of a PE and the corresponding taxability has remained a contentious issue the world over. With the recent initiatives taken by the Organisation for Economic Co-operation and Development's ("OECD") through its base erosion and profit shifting ("BEPS") project, the concept of taxing transactions based on where the real/significant economic activity has been performed, and in turn redefining the concept of PE, has gained more importance in the digitized business era.

In this background the Hon'ble Bangalore Tribunal ("Tribunal") in a recent case (*ABB FZ – LLC v. DCIT* [2017] 83 taxmann.com 86 (Bengaluru – Trib)) has recently analyzed the concept of a service PE and laid down some of the key principles diverting from the historic principles, in particular for the digital economy. The facts of the case and the principles laid down by the Tribunal are summarized below.

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Facts of the Case

ABB FZ-LLC was a company incorporated in the United Arab Emirates ("UAE"). It was engaged in the business of providing regional service activities for the benefit of ABB legal entities in India, the Middle East and Africa. Such services included regional occupational health and safety services, regional security services, regional business development services, regional group account management services, regional EPC services, regional project risk management services, regional market development services. For such purposes, its employees had visited India for 25 days during January—March 2010.

The contention of the taxpayer was that the consideration received by it for the services described above can be taxed as fees for technical services ("FTS"), and in the absence of any specific article on taxability of FTS under the India–UAE tax treaty, the income should be assessed under Article 22, "other income," of the India–UAE tax treaty. It was further contended by the assessee that Article 22 of the India–UAE tax treaty required the presence of a PE of the assessee in India in order to bring the payments received by it from rendering such services within the taxation net in India, and in the absence of the assessee's having any PE in India, the payments received by it for rendering such services were not taxable in India.

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However, the Tribunal , in addition to these aspects, also investigated and ruled on whether the taxpayer constituted a PE in India.

Principles Laid Down by the Tribunal

The Tribunal, in the course of articulating its ruling, laid down the following key principles.

Service PE

Article 5(1) and 5(2) of the India–UAE tax treaty relating to PE are independent clauses. Therefore, the condition of having a fixed place of business under Article 5(1) is not required to be satisfied for constituting a PE under Article 5(2).

It is generally understood that a service PE is constituted if services are furnished by an FE through its employees or other personnel in the source country for a threshold period (say for a period aggregating to six–nine months within any 12-month period). The Tribunal, in a layman's term, observed that to constitute a service PE it is not the stay of employees for the specified period which is required to be met, but rather continuous rendition of services by the FE for the specified period (irrespective of whether services are rendered through personnel or employees of a FE in India or not).

The Tribunal held that what is important is that services should continue to be performed for a period of more than nine months within any 12-month period. In other words, the manner in which services were performed is of no relevance in the context of provision of services.

The Tribunal also further held that since the activity of the taxpayer commenced only in the month of January 2010, the argument of completing nine months' service before March 2010 is implausible and against common sense: therefore, what is necessary is to satisfy the rendition of services by the personnel or employees of the foreign entity.

It was accordingly held that the taxpayer may have a service PE in India. However, since the India–UAE tax treaty specifies that other articles of the tax treaty would override the service PE clause, the Tribunal analyzed whether the consideration received for rendering services would constitute a royalty.

Detrimental to the Fundamental Principle of International Tax

It is to be noted that, in accordance with the fundamental principle of international tax, an FE shall constitute a PE in the source state—India in this case—only if the FE has an economic presence in India for conducting its business activities. Such economic presence could be either through a physical presence (through an office in India, visit of employees, personnel of Foreign Enterprise to India, etc.) or through a dependent agent in India.

What the OECD and UN Commentaries Have to Say on Service PE

OECD Commentary

The commentary issued by the OECD on the Model Tax Convention highlights the intention behind the placement of a service PE clause in a tax treaty and provides that in order to attract the provisions of a service PE, services must be rendered in the source state (OECD Commentary 2010 on Article 5).

UN Commentary

The UN Model Tax Convention also concurred with the view of the OECD that services should be performed in the source state in order to constitute a service PE. Responding to the concerns of the contracting states that the threshold prescribed may be misused by enterprises both in the case of a service PE as well as an installation PE as a result of modern technology, the UN commentary provided that the purpose of the bilateral treaties had been to promote international trade, investment and development, and the reason for the time limit had been to encourage businesses to undertake preparatory or auxiliary operations in another state that would facilitate a more permanent and substantial commitment later on, without becoming immediately subject to tax in that state (UN Commentary 2011 on Article 5).

Developments under BEPS for the Digital Economy

Under BEPS Action 1 on the digital economy (Addressing the Tax Challenges of the Digital Economy, Action 1: 2015 Final Report), the OECD gave due consideration to the TAG Report on "Treaty Rules and E-commerce: Taxing Business Profits in the New Economy (2005)" which had suggested to expand the definition of PE to incorporate "virtual fixed place of business", "virtual agencies", or "on-site businesses", but the OECD highlighted that the report concluded that it would not be appropriate to incorporate such changes at that time (Annexure—A Prior work on the Digital Economy—BEPS Action Plan 1).

BEPS Action 1 in its Final Report 2015 acknowledges the challenges of establishing "nexus" of digital businesses with a jurisdiction under current rules. Further, it examines that traditional PE rules may not be sufficient to address virtual presence. However, under the "next steps" (BEPS Action Plan 1— Final Report 2015 Digital Economy—Para. 385) it states that further work needs to be carried out by the working party of the Committee of Fiscal Affairs to clarify the characterization of certain payments under new business models of the digital economy, and further work needs to be done to design an inclusive post-BEPS monitoring process in relation to the digital economy.

Key Questions on Principles Laid Down by Tribunal

If the principles laid down by the Tribunal were to apply generally, then, in all cases, provision of services by an FE in its home country through its employees/personnel will be included for service PE purposes,

thus resulting in virtually all income-generating services of the FE which are rendered from outside India to be taxable in the source country under an implied service PE. This, however, does not seem to be the intent of a service PE in the first place. The above view therefore questions the logical interpretation of the term "provision/furnishing of services" and the relevance of "physical presence" of FE employees/personnel on the service PE front.

In the modern digital era, where services are supplied through digital modes, place of provision/furnishing of services should be the place where such means of communication have been initiated (although not specifically argued by the taxpayer or analyzed by the Hon'ble Tribunal), in the present case the home country of the taxpayer. If this interpretation of the Tribunal is carried forward, will all services rendered in digital form arise in the source country and be taxable therein?

Conclusion

It is worth remarking that technology should function as an enabler and not as a disruption in today's world, where services are increasingly being rendered by various technological tools. Care has to be taken to ensure that technology acts as a driver and not as a deterrent to carrying out business in various parts of the world.

In the absence of specific rules in the law, it is not clear how digital services would be brought to tax in India, except for the "equalization levy" which at present covers only advertising services.

It is quite likely that the higher courts will analyze this approach in greater detail and issue clear guidelines. However, in the meantime one can expect some litigation at the lower levels of the tax authority in relation to principles laid down by the Bengaluru Tribunal ruling.

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