Morison International

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Global Tax Insights

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Early this year, the US IRS released its Transfer Pricing Audit Roadmap – described as a *'toolkit that is organized around a basic audit time-line and that provides advice and links to useful reference material'*. The roadmap is the first document released in the area of transfer pricing, and this document should be reviewed by any multinational with controlled transactions involving companies in the United States. To my mind, the roadmap is useful for taxpayers as it brings clarity to the entire audit process. I hope that other countries will follow the US IRS's example by producing a document that will clarify expectations and reduce litigation.

Continuing the work on Base Erosion and Profit Shifting (BEPS), the Organisation for Economic Co-operation and Development OECD released 'Comments received on artificial strategies that might avoid PE status in source state'. The document explains how multinational companies can take advantage of the tax treaties to structure their operations in the source state so as to avoid the existence of a permanent establishment. The OECD update covers this aspect briefly.

This edition of the newsletter, besides the updates from various countries, incorporates two very important judgements from the Indian Courts. The first decision deals with the concept of gifting of shares by a company as part of a restructuring exercise; the other examines the concept of establishing a permanent establishment wherein only supervisory services are rendered.

I express my gratitude to all member firms that have contributed to this edition of the newsletter. I sincerely hope that the contents are useful to members and their clients. Feedback and suggestions on the contents are always welcome. Please email sachin@scvasudeva.com.

Happy reading!

Sachin Vasudeva
Senior Partner, S.C. Vasudeva, India

AUSTRALIA *Contributed by Michael Carruthers, Hayes Knight*

Distributor payments deemed software royalties

The Australian Federal Court in the case of *Task Technology Pty Ltd. v. Commissioner of Taxation* [2014] FCA 38 has held in favour of the Commissioner of Taxation that payments made by an Australian company to a Canadian entity under a distribution agreement were in fact royalties, and were therefore subject to non-resident withholding tax.

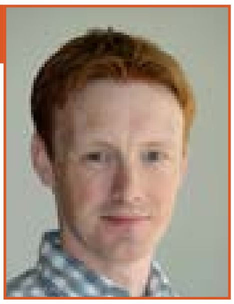
Under the distribution agreement the taxpayer was licensed to market and distribute the software pursuant to end user licences and to make copies of the software for distribution. The taxpayer was also able to develop and supply templates for use with the software.

The key issue in the case was whether the payments were classified as royalties under Article 12 of the Double Tax Agreement (DTA) between Australia and Canada. In particular, the case focused on whether the payments fell within the exclusion contained in Article 12(7), which provides that payments are not treated as royalties for the purpose of the DTA if they represent consideration for the supply of, or the right to use, source code in a computer software program, provided that the right to use the source code is limited to such use as is necessary to enable effective operation of the program by the user.

With reference to the OECD commentary, the Federal Court found that the payments were not excluded from being treated as royalties because the nature of the rights acquired under the distribution agreement were not limited to the rights that would be necessary for the effective operation of the software by the Australian company itself. The rights granted under the agreement enabled the taxpayer to commercially exploit the software by copying the software for sale to end users and gave the company the ability to use the copyright to develop its own templates to sell in conjunction with the software. This meant that the taxpayer was making a royalty payment to the Canadian entity, and withholding tax should have been withheld.

BELGIUM

Contributed by Jan Torsin (top right) and Gert De Greeve (bottom right), Van Havermaet Groenweghe



Changes in the beneficial tax treatment of expatriates

Belgium has an attractive special tax regime for foreign employees working for employers that are part of an international group (administrative circular, 8 August 1983).

1. The special tax regime

a. Conditions

In order to benefit from the special tax regime, both employer and employee must meet a number of conditions. The employer should be a Belgian company that is part of an international group or a subsidiary, branch office or permanent establishment of a foreign company which is part of an international group.

The employee cannot be a Belgian citizen; should exclusively perform activities that require a special knowledge and/or responsibility (executive functions); must maintain personal and economic ties abroad; and their employment in Belgium should be temporary.

Both the employer and the employee must send an application to the Belgian tax administration within 6 months from the first day of the month following the month of the start of the employment in Belgium.

b. Main benefits

If the application is approved by the Belgian tax administration, the employee will enjoy the following benefits:

- *Non-resident status for tax purposes.* Despite living in Belgium, the employee will be considered non-resident for the purposes of Belgian income tax. Personal income of non-Belgian source (interest, dividends, etc.) is not taxable and should not be reported on the Belgian income tax return.
- *Expatriate allowances or expense reimbursements are (partially) tax free.* There is a difference between one-time expenses and ongoing expenses. Allowances for one-time expenses (such as moving expenses or costs of establishing residence in Belgium) are not subject to Belgian income tax (there is no ceiling on the amount). Allowances for ongoing expenses (such as cost of living, housing allowances, annual home leave and travel expenses) are in principle not subject to Belgian income tax up to a maximum of €11,250 or €29,750 (the higher maximum is applicable for activities of a controlling or coordinating nature, or for scientific research).
- *'Travel exclusion'.* Perhaps most importantly, expatriates are not subject to taxation on salary income earned outside of Belgium. Salary income is thus taxable only to the extent that it relates to activities performed in Belgium. Salary income for activities performed outside of Belgium are not taxable in Belgium.

2. Belgian taxation of non-residents

As mentioned above, expatriates are considered to be non-residents. In Belgium, non-residents get the same tax benefits (such as tax-free lump sum, advantages for minor children, etc.) as residents if they obtain ≥75% of their worldwide income in Belgium or if they have a home in Belgium for the whole year.

Starting from income year 2014, non-residents will only get the same benefits as residents if they obtain ≥75% of their worldwide income in Belgium. So non-residents who have a home for the whole year in Belgium but do not obtain 75% of their worldwide income in Belgium will not get the same benefits as residents.

Most of the employees who benefit from the special regime have a home in Belgium for the whole year; so in the past, it wasn't important how much of their income they obtained in Belgium. They would always get all the tax benefits that residents get. Starting from income year 2014, this will change for some of them.

As a result of the change in the taxation of non-residents, expatriates with >25% income outside Belgium will no longer enjoy all the tax benefits of residents, and will therefore need to pay higher taxes.

INDIA *Contributed by Parul Jolly, S.C. Vasudeva & Co.*

Amendments made by the Budget 2014

The 2014 Budget, the first of the National Democratic Alliance (NDA), government, is progressive and aims to encourage investment-led sustainable and inclusive growth. Changes introduced by the Budget that have an impact on non-residents are discussed below.

Characterisation of income in case of foreign institutional investors

The definition of capital asset under Section 2(14) of the Income Tax Act, 1961 ('the Act') has been amended to include any security held by a foreign institutional investor that has invested in such security in accordance with the regulations made under the Securities and Exchange Board of India Act, 1992. Therefore, such securities would be treated as capital asset only and any income arising from transfer of such security by a foreign portfolio investor (FPI) would be in the nature of capital gain.

FPIs face a challenge in determining whether income arising from transaction in securities represents capital gain or business income; FPI fund managers often remain outside India in case their presence in the country has adverse tax consequences. The present amendment seeks to clarify for foreign investors how their income is characterised.

Rollback provision in Advance Pricing Agreement (APA) Scheme

Prior to the amendment made by Budget 2014, advance pricing agreements were valid for a period of up to five consecutive previous years, as may be mentioned in the agreement. The Act has been amended to provide a rollback mechanism in the APA scheme. The APA may, subject to such prescribed conditions, procedure and manner, provide for determining the Arm's Length Price (ALP) or for specifying the manner in which ALP is to be determined in relation to an international transaction entered into by a person during any period not exceeding four previous years, preceding the first of the previous years for which the advance pricing agreement applies in respect of the international transaction to be undertaken in future. This amendment will take effect from 1 October 2014.

Transfer of government security by one non-resident to another non-resident

Section 47 of the Act has been amended so as to provide that any transfer of a capital asset, being a government security carrying a periodic payment of interest, made outside India through an intermediary dealing in settlement of securities, by a non-resident to another non-resident shall not be considered as a transfer for the purpose of charging capital gains.

Transfer pricing

Introduction of range concept for determination of arm's-length price in transfer pricing regulation

Section 92C(2) of the Act covers provisions regulating the 'most appropriate method' for computing ALP in the case of international or specified domestic transactions. It provides that where more than one price is determined by the most appropriate method, the ALP shall be taken to be the arithmetical mean of such prices. This Section has been amended with effect from assessment year 2015–16. The amended Section provides that where more than one price is determined by the most appropriate method, the ALP shall be computed in such manner as may be prescribed. The manner of computation of the range is yet to be notified by the government.

Use of multiple-year data for comparability analysis under transfer pricing regulations to be allowed

As per existing provisions of transfer pricing regulations, only 1-year data can be used for comparability analysis, with some exceptions. These provisions are being amended to allow use of multiple-year data. The rules in this regard are not yet notified.

PERU *Contributed by Marysol León, Quantum Consultores*

Economic reactivation program

In an effort to boost the economy and encourage private investment, the Peruvian government has adopted an economic reactivation program that includes a number of tax measures, simplification of procedures and permits for the promotion and stimulation of investments in the country.

As part of the implemented tax measures, outlined below, the Peruvian government has made amendments to national legislation on sales tax and in their update on outstanding tax obligations.

'Debts outstanding' tax update

With the enactment of Law No. 30230, the outstanding tax debt payment – collection/administration of which is under the charge of the Tax Administration, including debts relating to Social Health Insurance (ESSALUD) and the Retirement Pension and Planning Office (ONP) – will be revised, eliminating the portion of interest on interest that had become due on the outstanding tax payment during the period 31 December 1998 to 31 December 2005.

The extent of reduction of tax debts amounting to a sum of more than 20,000 million Soles represents 20% of total tax liabilities and would benefit more than 180,000 taxpayers whose debts are believed to be uncollectable.

The Tax Administration Superintendent, Tania Quispe, has welcomed this measure, because in other countries there is no interest capitalisation on the tax debt.

Disposal of interests

In the Peruvian appellation system, any taxpayer with a resolution/decision issed against them was obliged to pay interest based on the tax debt, until the Tax Court issued a ruling based on an appeal filed by the taxpayer. As a measure of simplification, the taxpayer will now pay interest only for the first 12 months if the cause of the delay is attributable to the ruling body.

Sales tax

To prevent tax evasion, the tax authorities have three systems for prepayment of sales tax: detractions, reception and deduction (collectively known as the 'deductions system').

In the detraction regime, the purchaser of the goods and services must retain a percentage (1.5–12% of the total invoice) and deposit this to an account of the supplier in the National Bank. This amount can only be used by the Tax Administration to offset the supplier's tax debts.

This system has been strongly criticised by Peruvian entrepreneurs, who have objected that the advance payment of sales tax takes away the flexibility to invest and can also constrain their ability to meet other obligations, whether financial, employment or contractual.

The percentage of withdrawals has now been reduced from 12% to 10% for certain prescribed activities known as 'other business services' (legal activities, accounting, bookkeeping and auditing, tax advice, architectural and engineering activities and technical consultancy, advertising, research and safety).

Conventions for the avoidance of double taxation

In addition to the tax measures discussed above, from 2015, Peru will implement the agreements signed with the United Mexican States, Republic of Korea, Switzerland and Portugal for the avoidance of double taxation. These conventions are primarily based on the OECD model, but also incorporate some aspects of the UN model.

SWITZERLAND *Contributed by Bernhard Madörin, Artax Fide Consult AG*

Cross-border commuters

Switzerland and France have signed a mutual taxation agreement that also covers the taxation of cross-border commuters. It states that the right of taxation arises at the place of work and follows OECD regulations.

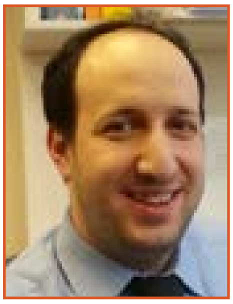
The recently renegotiated double taxation agreement with France has been signed by Federal Councillor Widmer-Schlumpf, but has yet to be passed by parliament. As a complete anomaly within this double taxation legislation, any inheritance of landed estate within Switzerland would be subject to French inheritance tax. The parliament, both chambers, has refused the governmental proposal, which has been negotiated between the French and Swiss governments. The tax treaty concerning income taxes, profit taxes and wealth taxes has been running since 1966, with some minor changes.

The implementation of taxation of cross-border commuters differs from canton to canton: Geneva collects ordinary tax at source from the cross-border commuters, based on ordinary income rate, and remunerates France with 3.5% of the taxable income. Basel-City foregoes taxation, and rather than deducting tax at source it receives a delayed payment of 4.5% of the taxable income. Geneva, on the one hand, can thus raise taxes of around 20–30% and cede 3.5%; France, on the other hand, can raise taxes in Basel-City of 20–70% while ceding just 4.5%.

Basel-City can be seen to fulfil a unique central function in this regard. In relation to the other cantons, the canton of Basel-City is losing out on the tax base to the surrounding boroughs and cantons, since taxation remains with the canton of residence. With a readjustment of the taxation of cross-border commuters, Basel-City could, on the basis of the existing double taxation agreement, massively increase tax revenue. On top of that, for high earners from France, taxation in Switzerland is far more attractive than taxation according to French regulations.

It is not just Basel-City that could profit from a readjustment of the taxation of cross-border commuters; the same applies to the cantons of Basel-Land, Jura, Bern, Neuchâtel, Valais and Vaud regarding workers commuting from France.

UK *Contributed by Chris Blundell (top right) and Ricky Noimark (bottom right), MHA MacIntyre Hudson*



UK Budget 2014

On 19 March 2014, the UK chancellor George Osborne delivered his budget to the UK Parliament which sets the tax rates/rules for the forthcoming tax year and onwards. Some key provisions are explained briefly here.

Share options for internationally mobile employees
Currently, how an employee is taxed on the exercise of their option is dependent on their tax residence position at the time of grant. If they are non-UK resident at the time of grant, no income tax arises on exercise even if they are UK resident at the time of exercise of their option. On the other hand, if an employee is a UK resident at the time of the grant, then they are technically liable to UK income tax on the whole share option gain (the difference between the share-market value on exercise and the exercise price) on exercise, even if the employee ceases to be a UK resident before the option vests or before it is exercised.

To counter this latter misalignment with OECD principles, Her Majesty's Revenue and Customs (HMRC) has in the past allowed an apportionment of the share option gain to the period of UK duties if the employee exercised the option in a country with which the UK had a double tax treaty. Only the part attributed to the UK duties was liable to tax. This concession was of no help where the employee went to a country with which the UK does not have a double tax treaty, such as Brazil, or to countries such as South Africa where special expatriate regimes mean the employee does not immediately become tax resident. These are the old rules, which will continue until 6 April 2015.

The new measures in the Finance Bill 2014 introduce a new approach to taxation where an employee has been internationally mobile during the 'relevant period' of an award. The 'relevant period' is essentially the period between the grant of an option and when it 'vests' (becomes exercisable). The share option gain is treated as accruing evenly day-by-day across the relevant period with one of the following treatments:

- Not taxable, as it relates to a period of non-residence in the UK in the relevant period where employment duties are wholly overseas;
- Taxable in full, because it relates to a period of residence in the UK; or
- Taxable to the extent it is remitted to the UK where the share option gain relates to duties performed abroad by a UK resident who is taxable on the remittance basis.

This new approach will have winners and losers. Employees holding vested options that were granted when they were non-resident may wish to exercise them before 6 April 2015 to minimise UK tax bills. Conversely, employees granted options while resident and working in the UK and who are now resident in countries with which the UK does not have a tax treaty, such as Brazil, may prefer to delay exercising their option until after 5 April 2015 in order to gain the benefit of some of their share option gain being apportioned to non-UK periods such that it is not UK taxable.

Annual Tax on Enveloped Dwellings (ATED) expanded
In April 2013, where a 'non-natural person' (any company irrespective of global location, a partnership with a UK partner or a collective investment scheme) owned a residential property valued at more than £2 million, the ATED has been charged unless the owner qualified for one of the property business reliefs (property development, buy to let, etc.). Hand in hand, there was also a 15% increase to the Stamp Duty Land Tax (SDLT) rate for non-natural persons when they purchased a residential property worth over £2 million. This was subject to the same reliefs for certain property businesses.

In an unexpected move, the Chancellor lowered the thresholds for the value of residential properties to be included in the scheme. From 1 April 2015, any residential property worth over £1 million and owned by a non-natural person will be within the ATED charge; this reduces further to £500,000 from 1 April 2016. He also announced the extension of the 15% SDLT band to be introduced immediately to any non-natural person purchasing a residential property for over £500,000.

Continued over

There will be a large number of companies and other non-natural entities with residential investment properties who will now be caught by the lower limits. It is important to plan ahead to determine whether these structures can be unwound or if there are other ways to mitigate the impending charges. Further, even if someone qualifies for an ATED relief, ATED returns must be completed and filed by 30 April of each year; or alternatively, where a property has been purchased midway through the year, 30 days after the purchase. Penalties are in place for failure to comply with the compliance aspects and have been issued by HMRC.

Capital gains tax (CGT) for non-UK residents

The UK government is continuing its consultation in the imposing of CGT on non UK residents. It previously announced details of the charge, but has yet to commit to a CGT rate or a method of collecting the tax. The new rules will apply to any residential property and not be limited to values (like ATED). It is likely that the tax will only affect gains after 1 April 2015 and will be withheld at the point of sale via solicitors/estate agents.

This does have wide implications for non-UK residents, as it is a large shift from the current policy of exemption that has been in place for many years.

OECD UPDATE *Comments received on artificial strategies that might avoid PE status in source state*

Background

The existence of a permanent establishment (PE) is a sine qua non for taxing the business profits of a taxpayer. Once a PE exists in the source state, income accruing or arising in such state is taxable in that state. A PE is generally taxable as per the domestic tax laws of the source state subject to restrictions if any under the Double Taxation Avoidance Agreement (DTAA). That being the position, examination of the taxpayer's PE in the source state becomes vital. There is a tendency among taxpayers to arrange their affairs in a manner that would not give rise to a PE in the source state.

The OECD Committee on Fiscal Affairs invited parties to submit probable strategies that might result in the artificial avoidance of PE status. OECD published the strategies that are generally adopted by multinational companies (MNCs) worldwide to avoid PE in source jurisdiction.

This article briefly explains these strategies.

Activities under the category of 'preparatory and auxiliary activities' – Article 5(4)

Para. 4 of Article 5 deals with exclusionary clause of 'preparatory and auxiliary activities'. Generally, these activities are considered as not triggering 'permanent establishment' for non-residents in source jurisdiction or jurisdiction in which such activities are performed.

The paper gives the following illustration to explain the aforesaid strategy.

Illustration for 'Exception relating to storage, display and delivery of goods':

- A Ltd, resident of Country A, maintains its storage house wherein it stores goods for display and delivery in Country B
- B Ltd will take delivery of goods as and when required from the warehouse/storage house of A Ltd
- In view of the facility being maintained for storage and delivery of goods, the case of A Ltd falls within Article 5(4) of the OECD Model Convention. Hence, A Ltd does not trigger any PE in Country B.

This exclusion is too general, and applies equally to situations when goods are stored in source state as per order received from the customer, or when goods are stored in source state in anticipation of demand from customer without any prior order. Thus, in the latter situation the exclusionary clause can be misused.

Illustration for 'Exception relating to processing of goods':

- A Ltd, resident of Country A, sends raw material to B Ltd, resident of Country B, to process the raw material as per specification and standards notified by A Ltd
- B Ltd processes the goods and sends the finished goods to A Ltd as per the instructions of A Ltd
- While goods are being shipped and in transit, through high-sea sales, A Ltd sells goods to C Ltd, in Country C
- In view of the activity of A Ltd in country B being merely processing of goods, the same is covered by Article 5(4) of OECD Model Convention.

This exception requires to be re-examined from classification as 'auxiliary' in character. Processing of goods in a particular jurisdiction clearly indicates an economic activity, and hence such activity should not be considered as 'auxiliary or ancillary in nature'.

Article 5(5) on dependent agency PE

Enterprise is deemed to have agency PE only if a person acting on its behalf habitually exercises authority to conclude contracts in name of enterprise. Therefore, to avoid the situation, the agency agreements are drafted in a way that MNCs take away the signing authority from the agent. Therefore, although an agent often performs activities such as product marketing, representation before prospective customers, soliciting orders and negotiating terms, they do not constitute agency PE.

Independent agency PE under Article 5(6)

An agent does not create a PE for their principal, provided that they act with independent status and in the ordinary course of their own business

Continued over

To determine the independent status of an agent, emphasis is being put on the quantity of business being transacted with the various parties/principals that they are representing. However, while examining independent status of the agent, fact of the principals/ entities for which the agent is working is being largely neglected. Many MNCs have one legal entity, having established in source jurisdiction that they will act as an agent for various legal entities, but also belong to/are part of the same MNC group for products being sold in the same source jurisdiction.

Change in criteria of 'permanency'

The concept of 'permanency' has become redundant in the digital economy, which makes it easy for a person to perform activities in a country without having a fixed place of business.

Professionals who are deriving income from delivering lectures or seminars are generally not taxed in absence of a place of business from which they are carrying out this activity. To deal with such situations, emphasis should be given on performance of an activity in the source country rather than on permanency in the place where such activities are performed.

Redington (India) Limited v. JCIT (ITA No. 513/Mds/2014) (Chennai Tribunal)

Contributed by Padmini Khare Kaicker (top right) and Bhavin Shah (bottom right), B.K. Khare & Co.

Transfer of shares made by the corporate taxpayer to its step-down subsidiary is a permissible gift, eligible for exemption under Section 47(iii) of the Income-tax Act, 1961('the Act'). The gift of shares is not a taxable transaction and therefore, not subjected to transfer pricing provisions

Facts of the case

The taxpayer provides end-to-end supply chain solutions for all categories of information technology (IT) products. The taxpayer provides supply chain solutions primarily in India, the Middle East and Africa. The taxpayer has a wholly owned subsidiary company, RGF Gulf. RGF Gulf is engaged in the same line of business carried on by the taxpayer. RGF Gulf is mainly focusing its operations in Middle East and African countries.

In the year under appeal, the taxpayer had initiated setting up of certain wholly owned subsidiary companies. The object was to attract investments to expand its business operations in Middle East and African countries and also for quoting its shares in stock exchanges abroad.

The taxpayer first set up a wholly owned subsidiary company in Mauritius in July 2008, RIML Mauritius. The taxpayer made an initial investment of US$ 25,000 (equivalent to 1.078 million rupees). The said newly set-up subsidiary, RIML Mauritius, in turn, set up its own wholly owned subsidiary, RIHL Cayman, in the Cayman Islands. Following these incorporation exercises, the taxpayer transferred its entire shareholding in RGF Gulf to RIHL Cayman on 13 November 2008.

Contention of the tax authorities

The corporate tax assessing officers (AO) and transfer pricing officers (TPO) treated the above gift of shares as taxable transfer and denied the claim of the taxpayer that the said gift is exempt under Section 47(iii) of the Act.

The AO/TPO further held the said gift as an international transaction and determined the arm's-length price (ALP) of 8.65 billion rupees.

Contention of the taxpayer

Section 45 of the Act comes into operation only when a transfer takes place for consideration and profits or gains arise out of such transaction. There is no consideration involved in the impugned transfer of shares and therefore, the question of computing profits or gains does not arise. Since the transfer of shares was made without consideration, charging Section 45 is not attracted. The taxpayer also contended that as per Section 47(iii), a gift is not considered as a transfer.

The taxpayer further contended that the transfer of shares by the taxpayer in its subsidiary, RGF Gulf, to its step-down subsidiary, RIHL Cayman, does not dilute or diminish the value of the taxpayer's asset base. As the transfer is only an appropriation within the same group and the taxpayer retains ultimate control as the holding company, nothing has gone out of the group and, therefore, it is not possible to construe the impugned transfer of shares as transfer of a capital asset generating capital gains.

As the shares were transferred without consideration, it is not an international transaction. In order to come under the purview of an international transaction, the transaction must generate income. On the basis of the above premises, the taxpayer did not offer the transfer of shares as an international transaction.

Decision of the Court

There is nothing against a company making a gift of its property to another company. A transfer without consideration, when claimed as a gift, is always a gift; it cannot be construed any other way. There is nothing anywhere in law prescribing that only natural persons can make a gift on the grounds of 'love and affection'. The transfer of shares made by the assessee to its step-down subsidiary, RIHL Cayman, is a gift eligible for exemption under Section 47(iii). Accordingly, no capital gains can be brought to tax on the transfer of shares.

Continued over

Section 92 provides that any income arising from an international transaction shall be computed having regard to the ALP. The computation of the ALP is therefore dependent on the income arising to a taxpayer from an international transaction. In the present case, the shares were transferred by way of a gift and no income arose in the hands of the taxpayer. ALP determination does not extend to any transaction that does not generate taxable income. The gift of shares made by the taxpayer company cannot, therefore, be subjected to TP provisions.

EDITORIAL COMMENT

Recent amendments to the Indian tax laws needs to be evaluated to assess whether a corporate gift of shares will continue to be tax exempt, even after the above positive ruling, as certain amendments seek to bring such gifts of shares, in certain circumstances, subject to tax in the hands of the receiver.

GFA Anlagenbau GmbH v. Asst. DIT(IT) (ITA No. 1292/Hyd/2011)

Contributed by Padmini Khare Kaicker (top right) and Bhavin Shah (bottom right), B.K. Khare & Co.

Supervisory activities carried in India for more than 182 days would not trigger PE without the foreign company having a building/construction site of its own. Fees for supervisory services would be taxed as fees for technical services, as per the tax treaty

Facts of the case

The taxpayer is a foreign company incorporated in Germany. It is engaged in the activity of supervision, erection, commissioning of plant and machinery for steel and allied plants in India. The taxpayer filed the return of income for the assessment year 2005–06 reflecting gross receipts of INR 81,932,566.

During the year under consideration, the taxpayer had received contractual receipts aggregating to INR 81,932,526 from TISCO Bombay, SMS Demag Pvt. Ltd, New Delhi, Jindal Strips Ltd., Bhubaneshwar and Steel Authority of India Ltd (SAIL) for rendering technical and supervision services. It was noticed that the taxpayer had rendered services to the above-mentioned resident companies by engaging foreign technicians at the worksites in India, and that the total stay of technicians deputed by the taxpayer on one project in the case of Jindal Strips Ltd had exceeded 183 days (220 days).

Contention of the tax authorities

On the basis of these particulars of stay of foreign technicians in India, the AO concluded that the taxpayer had a PE in India, within the meaning of Article 5 of the tax treaty between India and Germany.

The AO proceeded to assess the total contractual receipts of INR 81,932,526, after allowing deduction at 50% from the gross receipts towards expenditure incurred in relation to the execution of contracts, and determined the income at INR 40,966,263. The AO imposed income tax applying a rate of 40% in addition to surcharge and education cess, as applicable under the provisions of Section 44DA of the Act, i.e. treating the same as profits and gains of the business.

Contention of the taxpayer

The taxpayer contended that it does not have a fixed-place PE in India, as the taxpayer renders its services at the project sites of its clients and does not by itself own or operate such sites independently.

Decision of the Court

The Tribunal noted that under the Income Tax Act, 1961 ('the Act'), the definition of a PE in Section 92F (iiia) 'includes a fixed place of business through which the business of the enterprise is wholly or partly carried on'.

The supervisory activities do not constitute a fixed place of business, in as much as the taxpayer renders its services at the project sites of its clients and does not by itself own or operate such sites independently.

The concept of 'fixed place of business' in the Act is no different from the general provision of Article 5(1) found in the Model Conventions and the Indian Treaties.

The Assessing Officer has not invoked the service PE concept while considering the PE of the taxpayer in India. Just because these technicians stayed in India while supervising the work undertaken by the taxpayer in India, it cannot be considered that their place of stay can be 'fixed place of business' for the taxpayer.

A literal reading of Article 5(2)(i) of the Treaty leads to the conclusion that supervisory activities by themselves cannot constitute a PE. These are to be rendered in connection with a building, construction or assembly activity of the non-resident, which is not the case here as the taxpayer provides only supervisory services.

Article 5(2)(i), though it talks about supervisory activities, does not cover the instant case as taxpayer has no building site or construction site of its own; the ownership of such a building/construction site, where such supervisory activities are carried out for more than 183 days, is a prerequisite in determining PE according to Article 5.

Continued over

The activities carried on by the taxpayer were of a technical nature and therefore taxable as fees for technical service as per Article 12 of the tax treaty between India and Germany, taxable at the rates specified therein.

EDITORIAL COMMENT

The India–Germany tax treaty has no service PE clause; the Tribunal has therefore rightly held that in the present case the taxpayer did not have a PE in terms of Article 5 of the tax treaty, as supervisory activities by themselves cannot constitute a fixed-place PE. Had there been a service PE clause, then the decision of the Tribunal might have been different.

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The Next Step

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