COVID-19: Forced Residency and Unintended Tax Consequences in Times of a Lockdown

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The COVID-19 pandemic has led to unprecedented times for the world. Many countries, including India, most of Western Europe and some states of the US have now imposed mandatory lockdowns, in addition to restricting international travel in order to reduce the number of cases, "flatten the curve" and avoid overburdening the healthcare infrastructure. These lockdowns, and consequent home office situations have led to unintended tax consequences for individuals and corporates at large.

In India, the lockdown/ ban on international travel has been somewhat of a snap decision owing to the urgency of the pandemic, giving no time for corporates or individuals to plan their stay in a particular jurisdiction. Therefore, global citizens and HNIs who spend time in multiple jurisdictions through the year, and are in the midst of a lockdown in a country (in which they may not have intended to remain for an extended duration), may find themselves to be tax residents of such countries. While some countries, such as India are implementing lockdowns for an initial period of 2-3 weeks, going by the example of China, Italy and Spain, it appears that the pandemic could take at least 4-6 weeks to peak, extending lockdowns to a longer period.

Individual residency

Globally, the day count test has been the most widely used test of individual residency. For example, in India, if a person spends 182 days in India in a financial year, s/he is considered to be Indian tax resident and thereby taxed on worldwide income. Another test for residency where a person spends 365 days or more in the last four years, and 60 days or more in this financial year. While the pandemic is a global emergency, and does not indicate the intention of an individual to reside in a particular country, as tax residency tests are day count based and not intention oriented, it could be so that global citizens become residents of a particular jurisdiction owing to the lockdown. As in the case of India – the threshold could even be as low as 60 days in a financial year (see test above). While India also has a concept of "resident but not ordinarily resident" that provides a transition period of two years typically for foreign nationals in India before they are taxed on a worldwide basis, this may not be relevant for individuals who may have been coming to India on a regular basis over the years, or have been Indian tax resident in the past.

Therefore, given these circumstances, an exemption from the day count test during the period of (i) mandatory lockdown and (ii) ban on international / domestic travel should be provided, as the law itself may not be equipped to handle an unprecedented situation of this sort as the test is objective and does not leave much wiggle room.

Corporate residency

Owing to the presence of key managerial persons, directors of a foreign company in India could lead to the foreign country being resident in India if its place of effective management (POEM) is in India. The POEM test is also relevant as the tie breaker test in a dual residence situation under most tax treaties. The POEM of a company would of course depend upon where the board meetings are conducted and decision making is carried out over the course of the year. The POEM test will need to be looked at holistically and the effective management during a temporary lockdown should not be a guiding factor. Unlike the individual tax residency test, the POEM test is subjective and dependent upon the facts and circumstances of the case. However, a pandemic of this magnitude is a new circumstance and therefore it would be useful for tax departments to provide guidance to tax officers (if not a complete exemption) on how to deal with this situation. The concern becomes real especially if a lockdown is to continue for more than 2-3 months. Meanwhile, companies may take preventive measures such as postponing important meetings unless urgent, non attendance of directors quarantining or self isolating in other jurisdictions in board meetings of the foreign companies.

Two connected issues to the above are – (i) establishment of a permanent establishment owing to the activities of key managerial personnel (KMP) or employees of a foreign entity in the source country and (ii) withholding tax consequences for salary payments to employees in the source country.

Permanent establishments (PE)

In the pandemic, there can be two or three relevant types of PE under tax treaties. Firstly, fixed place PE is constituted where a business of the foreign enterprise is carried out in the source country owing to the employees or KMP working from home. The lack of permanency of these business activities and the home office not being at the disposal of the foreign enterprise, both of which are key ingredients of a fixed place PE should help in mitigating this risk. However, in the absence of judicial precedents, aggressive tax officers, especially in jurisdictions such as India, may take a different view, leading to PE related tax assessments for foreign entities.

A similar risk also exists in so far as (dependent) agency PE is concerned, where KMP or employees negotiate or conclude contracts on behalf of their employers, albeit the test of habituality should not be met.

The OECD believes that both the home office situation and the temporary conclusion of contracts by employees in the source country is a result of a force majeure event, and not at the foreign entity's behest and should therefore fall outside the scope of fixed place and agency PE respectively, unless it becomes the norm over time.

A higher risk of service PE exists (in case of Singapore, USA, and UK tax treaties with India), considering that these treaties operate on a 90 day threshold i.e. if services are provided by employees of a foreign entity in the source country for a period of 90 days or more in any given 365 day period, a service PE may be constituted. The service PE test is more of an objective test that may not take into account the context of the pandemic.

Also, given the proximity of territorial borders in EU, it is quite common for employees to live in a certain country and work in another under regular circumstances. However, owing to the work from home policy, the place of habitat is also the place of employment. The Belgian, Luxembourg and French governments have confirmed that the pandemic be treated as a force majeure event for the purposes of the relevant treaties, and mobile working activities performed by workers in one state who are employed by another should not be taken into account while determining to 24 or 30 day rule as applicable under the relevant treaty, as the maximum period of activity allowed outside the employer's jurisdiction while remaining exclusively taxable in the employer jurisdiction.

A similar clarification in relation to constitution of PE and POEM, released by the government of the source country would be beneficial to global businesses.

Other issues that require further deliberation are – Whether the salary income of an employee is taxable at the home jurisdiction or the employer jurisdiction? Would withholding tax obligations need to be complied with by the employer in such circumstances?

These international tax issues have of course not been on the top of the economic agenda for many countries. However, some countries have been forthcoming in taking note of these issues. For example, Australia has released various guidelines on circumstances in which a foreign individual should not be taxed on salary income earned while in Australia owing to the pandemic, or treated as Australian tax resident owing to their day count test being fulfilled due to the pandemic (provided that intention to stay outside Australia and past overseas residence can be established). Similarly, the guidance also notes that Australian tax residency of a foreign company should not be established simply because board meetings are conducted in Australia owing to presence of directors there due to the pandemic; neither should a PE be established owing to COVD-19 related circumstances. Ireland has also issued guidance to disregard presence of directors or employees in Ireland of a foreign company for tax purposes, if such presence is owing the COVID-19 related travel restrictions. UK has also issued similar guidance.

The OECD has also recognized the issue in a recently released guidance, but appears to be of the view that the existing framework for constitution of PEs and tie breaker tests for residence should be sufficient to deal with the pandemic situation.

However, in our view, each country will react differently, and it is important for governments to either provide blanket exceptions or at the minimum, guidance to the tax officers on how to deal with such cases. Of course, there are bound to be cases which blur the distinction of presence due to a COVID-19 lockdown versus an intention to stay, especially where past travel history and trends over the years is being looked at to establish intention to stay. This ultimately will be more of a subjective test, driven by facts and circumstances of each case. As is the case with all issues concerning the pandemic, one can only wait and watch to see how the situation unfolds, and whether or not companies will have to adapt and do business differently.