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Addressing tax challenges of the digital economy: fair play or foul play?

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"The judge who always likes the results he reaches is a bad judge," Justice Antonin Scalia had famously said. A recent ruling delivered by the Bengaluru Bench of the Indian Income Tax Tribunal in *ABB FZ-LLC vs. Deputy Commissioner of Income Tax* (pronounced on June 21, 2017) is a case in point. In what was a fairly simple case of application of the India-UAE tax treaty, the Tribunal handed down a 80-page judgment to hazily conclude that a foreign company can: (a) be taxed under the fees for technical services (FTS) provision of the Indian Income Tax (IT) Act in the absence of a FTS clause in the treaty; and (b) have a service permanent establishment (PE) in India even if the foreign company is providing virtual services (that is, from UAE) for utilization in India.

The Service Agreement

The facts of the case are as follows: the taxpayer (a UAE-based company) entered into a Service Agreement with an Indian company for provision of services during the 2009-10 and 2010-2011 financial years for which it received a total consideration of over INR 80 million. Some of the services were provided through video conferencing, emails, phone etc. from UAE itself. During the disputed period, the taxpayer's employees visited India for a period of less than nine months. Here, it is important to note that the Tribunal eventually held that the amount was taxable in India as it constituted "royalty income" for the purpose of Article 12 of the treaty. Though tempting, I will not discuss the royalty aspect of the case here (the Tribunal's approach on the question of residence, though unusual, is also not discussed in this blog). I will only discuss the Tribunal's observations pertaining to service PE and tax treatment of FTS.

"…through its employees in the other Contracting State"

According to Article 5(2)(i) of the India-UAE tax treaty, PE includes "*the furnishing of services including consultancy services by an enterprise of a contracting state through employees or other personnel in the other contracting state, provided that such activities continue for the same project or connected project for a period or periods aggregating more than nine months within any twelve-month period*." (emphasis supplied)

Upon applying the Article to the facts of the case, the Tribunal concluded the following:

> *…Furnishing of services including consultancy services by taxpayer for the project in India for a period of three months after commencing its activities in January 2010. Thus it fulfills the prerequisites of service PE…service PE does not require PE as well. In the present age of technology where the services, information, consultancy, management etc can be provided with various virtual modes like email, internet, video conference, remote monitoring, remote access to desktops etc through various software, therefore, the argument…that three employees rendered services only for 25 days cannot be sustained.*

> *Clause (i) of Article 5(2) which provides the service PE, is not dependent upon the fixed place of business as is only dependent upon the continuation of the activity for the project for a period more than nine months. Accordingly, we hold that the taxpayer is having the service PE in India. As per our reading it is not the stay of the employees for more than 9 months, which is required to be there, but it is fact of rendering of services or activities which was required to be rendered for a period of nine months.*

The moot point here is that the taxpayer's employees rendered services within India only for 25 days in a three-month period from January to March 2010. Therefore, the condition of stay in India for nine months is not fulfilled in the present case. It was not the case of the taxpayer that service PE is dependent upon the fulfillment of the requirements of Article 5(1) or that a service PE necessarily implies a physical PE. The taxpayer made a very limited submission that on a plain reading of Article 5(2)(i), the threshold requirement of nine months was not fulfilled and therefore there cannot be a service PE within the meaning of Article 5(2)(i) of the treaty.

The taxpayer's position is not very difficult to grasp. Article 5(2)(i) envisages a situation where employees of a foreign company stay in India for a minimum period of nine months. The Article, as it stands today, does not envisage a situation where services are performed from outside India and the Tribunal's view effectively amounts to rewriting of Article 5(2)(i). In other words, it is not the duration of the provision of services that would trigger a service PE in India, but the duration of the stay of the employees of the foreign company in India and in the instant case, the taxpayer's employees were not present in India for the stipulated threshold period.

Article 5(2)(i) is a stand-alone provision

Unlike the UN Model which provides for a separate clause on service PE, the India-UAE tax treaty (much like the India-UK tax treaty) has the concept of service PE included in the list of illustrations set out in Article 5(2). Readers will recollect that in a recent case before the Tax Court in South Africa (involving the South Africa-US tax treaty), the taxpayer had argued that the words "includes especially" mean that the provision of service PE in Article 5(2)(k) of the South Africa-US tax treaty is subject to the fulfillment of Article 5(1), that is, there cannot be a service PE without a physical PE. For a detailed analysis of the ruling, please see Jonathan Schwarz's blog here.

There, the South African Tax Court concluded that Article 5(2)(k) is a self-standing provision as it deals with a "form of work" and not with a "place of work" as denoted by other illustrations set out in Article 5(2)(a) to Article 5(2)(j). The Tribunal in the instant case did reach a similar conclusion:

> *The clause 2 of Article 5 is by way inclusive definition in nature and the definition given in clause (1) of Article 5 has been enlarged by Clause 2, therefore, Article 5(2) does not require fulfilling the requirement of Clause 1 of Article 5. Article 5(2) is independent clause and the condition of having fixed permanent place of business under Article 5(1) is not attracted for permanent establishment under Article 5(2).*

It is not clear from a reading of the ruling if the taxpayer made any contrary submissions or not but the Tribunal's conclusion in this regard is consistent with earlier judicial pronouncements in India and also in line with the objectives of Article 5(2)(i).

The issue of FTS

The taxpayer argued that the income is not taxable in India as it is in the form of FTS and the India-UAE tax treaty does not contain a specific FTS Article. The taxpayer submitted that Article 22 of the tax treaty (other income) also cannot be invoked in such a case given that the taxpayer does not have a PE in India. The Revenue however maintained that the services fall under the category of FTS as defined under section 9(1)(vii) of the IT Act (Explanation 2) and therefore are liable to be taxed in India even if the tax treaty does not contain a specific FTS Article.

The Tribunal began its observations by stating that "it will be violation of the principles of interpretation that if a clause which is not mentioned or defined in the treaty would be permitted to be read in the treaty." No one will question this cardinal principle of treaty interpretation. But the question is what exactly is the Tribunal seeking to "read into" the treaty? According to the Tribunal, Article 22 would become redundant if residual income is to form part of business income. Again, no one will disagree. But there is no explanation in the ruling why in the absence of a specific FTS Article in the treaty (assuming it is not royalty income) the income would not fall under Article 7 of the treaty. Indian Income Tax Tribunals have previously held that in the absence of a FTS article in tax treaty, the fees received by a non-resident company would be taxed under the business profits Article of the tax treaty subject of course to the existence of a PE in India.

Rewriting the law

I must point out that the ruling to some extent takes note of the tax challenges that digital economy today poses in the determination of a PE. The issue of virtual PE also finds mention in the OECD's work on BEPS Action 1 (although the proposals were later dropped from the final 2015 Report on Action 1). There were concerns raised by businesses about the double taxation risks that such a move will pose as well as the problems in defining the concept of "significant digital presence" (and the difficulty in attributing profits). India's unilateral action to legislate a six percent equalization levy to tax digital payments has already received flak from scholars worldwide and rightly so. In any event, the question is not what the law ought to be but what the law actually is (to be complied with in good faith) and rewriting of the treaty will lead to unintended taxation.

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