

Dependent Personal Services

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INTRODUCTION

In the times of globalisation, transnational organizations, having operations in multiple countries need to employ individuals across countries. The global mobility of employees has become even more critical in the wake of the requirement of specialized technical skill and expertise. Today, a company, located in country A is in a position to employ a person from country C for its operations in country B. The company may or may not have a subsidiary or a permanent establishment in country B. The employee may be sent to country B only to perform certain functions and hence may be stationed in that country only for a limited period of time. In view of this, taxation of the salary received by such an employee assumes tremendous importance. While the country of residence of the individual would like to tax the individual on his worldwide income, the country of source, where the individual performs his duties would also want to tax the income under the source rule. This could lead to a potential double taxation. Bilateral tax treaties entered into between countries for avoidance of double taxation have addressed this situation by making provisions under the article "Dependent Personal Services". There are specific provisions in the Income Tax Act, 1961 ("IT-Act") dealing with such situation. In this article, we discuss taxation of Dependent Personal Services under bilateral tax treaties ("Convention") and its interaction with the domestic laws of some countries.

Employment income has traditionally been styled in Conventions as 'Dependent

Personal Services'. For dealing with cross border income of individuals, the Convention had two articles: Article 14¹, dealing with "Independent Personal Services" and Article 15, dealing with "Dependent Personal Services". In the year 2000, the OECD deleted Article 14 from the Model Convention, since it is thought that the Article on Business Profits (Article 7), would adequately deal with the income of an individual rendering services as an independent professional. As a result, Article 15 is now simply referred to as 'income from employment', a more commonly used term, which makes the heading more consistent with the type of income that it deals with. However, some old Conventions do not make a distinction between independent and Dependent Personal Services, e.g. Article 9(2) of the tax treaty between United Kingdom and Antigua.

Text of Article 15: Dependent Personal Services

The text of this article under the UN Model Convention and the OECD Model Convention is the same. It is reproduced below for easy reference:

1. *"Subject to the provisions of Articles 16 (Directors' Fees), 18 (Pensions and Social Security Payments) and 19 (Remuneration in respect of Government Services), salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the*

employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State.

2. *Notwithstanding the provisions of paragraph 1, remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first mentioned State if:*
 - (a) *The recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in the fiscal year concerned; and*
 - (b) *The remuneration is paid by, or on behalf of, an employer who is not a resident of the other State; and*
 - (c) *The remuneration is not borne by a permanent establishment or a fixed base which the employer has in the other State.*

3. *Notwithstanding the preceding provisions of this Article, remuneration derived in respect of an employment exercised aboard a ship or aircraft operated in international traffic or aboard a boat engaged in inland waterways transport, may be taxed in the Contracting State in which the place of effective management of the enterprise is situated."*

SCOPE

The term "Dependent Personal Services" is not defined under any of the Model Conventions. Representative examples have been cited which would typically fall under this article. Thus, this term is to be derived on the one hand by distinguishing it from other types of activities (e.g. business profits and independent personal services) and on the other hand by referring to a common international understanding of this term. Dependent Personal Services may therefore be

presumed to exist if a person (the employee) makes his capacity of work available to another (the employer) and in performing such activities, the former is obligated to follow the directions and instructions of the employer. Both, from the employment law as well as from the tax law perspectives, the *integration* of the dependent activity into the enterprise of the employer is crucial so as to make the employee bound by the directions and instructions of the employer.

OFFICE VERSUS EMPLOYMENT

"Employ" means use services of (person in return for payment, use (thing, time, energy, etc.), keep (person) occupied² while "employment" means an act of employing. Thus, the concept of employment involves three ingredients, viz. (a) employer, (b) employee and (c) contract of employment. An office is defined as a '*position or post, which goes on without regard to the identity of the holder of it from time to time*³. In general, the distinction between the office and employment is not material and thus there is no precedent to state that an office-holder is to be excluded from the provisions of Article 15. However, the exception to this general rule exists in case of remuneration to directors of a company, which is specifically governed by the provisions of Article 16 of the OECD Model Convention. In the case of *Barry V. Farrow*, [1914] 1 KB 632, the English Court held that a company director is regarded as holding an office rather than having an employment.

DEFERRED REMUNERATION

Difficulties could arise while distinguishing between Article 15 and 18, for instance remuneration paid after an employment has ceased may either be wages or salaries paid in retrospect, and thus fall within the ambit of Article 15. If it is paid by way of pension, it could fall within the ambit of Article 18. The distinction in such

cases must be made by considering the reason of the payment, rather than the point of time when the payment is made. Severance pay designed to ease the burden on employees moving to another job or switching to a different occupation and especially those paid on premature dismissal and designed to bridge a waiting period would be governed by the provisions of Article 15 since all such payments are based on the employer-employee relationship⁴. However, severance pay granted in lieu of a pension when employment comes to an end should be taxed in accordance with the provisions of Article 18.

TAX YEAR CONCERNED

The first condition for the remuneration to qualify for the exemption under the Convention is that the period of stay in the State where the services are rendered is limited to 183-days. Additionally, this time period may not be exceeded 'in any twelve month period commencing or ending in the fiscal year concerned'. This contrasts with the 1963 Draft Convention and the 1977 Model Convention which provided that the 183 day period should not be exceeded 'in the fiscal year concerned', a formulation that created difficulties where the fiscal years of the contracting states did not coincide and which opened up opportunities for the taxpayers to organize operations in such a way that, e.g. workers stayed in the State concerned for the last 5 ½ months of one year and the first 5 ½ months of the following year so as to qualify for the exemption under Article 15⁵. The present wording of the Article has plugged the loophole for such planning opportunities. The US Revenue Ruling, 86-145⁶, delivered in 1986 in relation to the applicability of US-UK Convention is relevant in this connection. This is discussed below briefly.

Facts: Mr. X, a United Kingdom resident, was present in the United States for more

than 183 days in 1985. X performed personal services during that period for an employer who was not a resident of the United States and who had no permanent establishment or fixed base in the United States. With respect to 1985, X was a resident of the United Kingdom and was not deemed a resident of the United States under Article 4 of the Convention. X was present in the United States for 30 days in 1986 and during that period he was paid for the services performed when present in the United States in 1985. In each of those years, X's United States tax year was the calendar year.

Ruling: "For purposes of the 183-day limitation for the exemption under Article 15(2)(a) of the Convention, the term 'tax year concerned' refers to the tax year in which the services being compensated are performed in a Contracting State by a resident of the other Contracting State and not to the tax year in which compensation for services is received."

As far as India is concerned, the principle that location of income from employment is the place where the taxpayer performs his duties of employment has been incorporated in section 9(1)(ii) of the IT-Act, which stipulates that if the salary is earned in India, it is deemed to arise in India. Thus, where an employee carries out his duties in India, the salary received by him in the first instance attracts taxability in India irrespective of the place of payment or of the contract of employment or his residential status. Then the other provisions under the IT-Act and/or a Convention are considered for determining whether or not tax is payable in India on such salary.

COMPUTATION OF THE 183-DAY PERIOD

Computation of the 183-day's presence assumes a great deal of importance. The OECD Model Convention has endorsed the

'days of physical presence' method for the purpose of calculation of the 183-day period under Article 15⁷. Under this method the following days are *included* in the calculation:

- part of a day,
- day of arrival,
- day of departure
- Saturdays and Sundays spent inside the State of activity
- national holidays spent inside the State of activity
- holidays spent inside the State of activity
 - ❖ before exercising the activities
 - ❖ during exercising the activities
 - ❖ after exercising the activities
- short breaks spent inside the State of activity
- days of sickness, unless they prevent the individual from leaving and he would have otherwise qualified for the exemption
- days spent inside the State of activity due to
 - ❖ death or sickness in the family
 - ❖ training
 - ❖ interruption on account of strikes or lock-outs
 - ❖ interruption on account of delays in supplies

However, the following days will be *excluded* for calculation of the 183-day period:

- transit between two different points outside the State of activity if the individual is present in the State of activity for less than 24 hours
- holidays spent outside the State of activity
- short breaks (for whatever reason) spent outside the State of activity.

Thus, a day during any part of which, however brief, the taxpayer is present in a State counts as a day of presence in that State for the purposes of computing the 183-day period. This could differ from

the administrative practice followed in the respective Contracting States in relation to determination of residence in that State. In view of different approaches in calculating the presence under the domestic laws of that State, it would be necessary to consider each case separately, based on the facts of the case for determining the 183-day presence under a Convention.

As per the Treasury Department Technical Explanation of the United States Model Income Tax Convention of September 20, 1996, the same test as provided in the OECD Model Convention has been endorsed for the purposes of the US Model Convention read with the Interpretation provided by the Inland Revenue Ruling: 56-24⁸, wherein the Court ruled:

"The word 'day' as used in relation to article XI(1) of the income tax convention between the United States and the United Kingdom of Great Britain and Northern Ireland, T.D. 5569, C.B. 1947-2, 100, with respect to the exempt status of compensation for personal services performed by a resident of the United Kingdom who is present in the United States for a period or periods not exceeding in the aggregate 183 days during the taxable year, is interpreted for United States income tax purposes to mean a day during any portion of which the resident of the United Kingdom was physically present within the United States. This interpretation will apply equally to all income tax conventions containing similar provisions."

ECONOMIC EMPLOYER VERSUS FORMAL EMPLOYER

It is the economic employer rather than the formal employer who should be considered as the employer for the purposes of Article 15. In such a determination triangular cases involving a

third country "employee pooling entity" become critical, wherein the overseas employer is based in a tax haven or it drops down a wholly owned subsidiary (called the employee pooling entity) which hires the employees and such subsidiary provides the services to the user of these services in the State of activity. In such a situation, though the formal employer may be the employee pooling entity, the economic employer would be the entity, which deposes the employee to the State where the services are performed. In considering the fulfillment of conditions (b) and (c) of paragraph 2 of Article 15, these facts may become important.

RESIDENCE OF THE EMPLOYER

The second condition for the remuneration to qualify for the exemption under the Convention is that the employer must not be a resident of the State of activity. Article 4(1) defines residence, which is to be determined as per the domestic law of the Contracting States. In case of dual residence, State of residence is determined by the application of paragraphs 2 and 3 of Article 4 for the purposes of applying the distributive rules of the Convention. These tests are not applicable in the context of Article 15(2)(b)⁹. They could be applied if the employer is a resident not only of the State of activity but also of the employee's State of residence. Thus, if the employer has a residence in both the Contracting States, he is a resident in the State of activity and the 183 day rule does not apply. This result is corroborated by the object and purpose of Article 15(2)(b) and (c) and the basis being the primary right of the State of activity to tax such income as provided in Article 15(1).

PAYMENT - NOT TO BE BORNE BY A PERMANENT ESTABLISHMENT

The third condition for the remuneration to qualify for the exemption under the Convention is that the remuneration should

not be borne by a Permanent Establishment¹⁰ ("PE") or a fixed base, which the employer has in the State of activity. This condition is designed to prevent impairment of the right of the State of activity to impose tax on such remuneration. The fact that the employer has or has not actually deducted the remuneration in computing profits attributable to such PE is not necessarily conclusive since the proper test is whether the remuneration would be allowed as a deduction for tax purposes, e.g. when no amount was actually deducted as a result of the PE being exempt from tax in the source country or because the employer simply decided not to claim a deduction to which he was otherwise entitled¹¹. However, inter-company charges borne by the PE would fall outside the scope of Article 15(2)(c).

EMPLOYEE STOCK OPTIONS

Cross border employee stock options are being used extensively by transnational entities to attract and retain talented personnel. The important issue that arises in such transactions is the question of characterisation of such options *i.e.* whether to be characterized as perquisites arising out of employment or as capital gains. Further, the issue of the point of time when such options should be taxed would also have to be determined. Options resulting in perquisites would in general form part of salary, which would need to be considered for the purposes of Article 15.

As far as India is concerned, this issue is fairly settled pursuant to the amendment to section 17 of the IT- Act by the Finance Act 2001 read with the Employee Stock Option Guidelines, 2001, issued by the Ministry of Finance ("MOF Guidelines"). As per section 17 of the IT -Act, shares allotted by a company to its employees at a concessional price under a stock option plan or scheme

drawn up in accordance with the MOF Guidelines would not be taxed as perquisites. This is known as single-point taxation i.e. no perquisite value tax at the time of exercise, and gains realized, if any, upon sale of shares allotted under the option plan would be taxed as capital gains at the applicable rates. In view of this, the grant of stock options would result in remuneration, falling within the ambit of Article 15 only when such stock options do not comply with the MOF Guidelines.

DOUBLE TAXATION AND DOUBLE NON-TAXATION

Double taxation or double non-taxation may result from the inconsistent application of the 183 day rule. Double taxation could arise in a case where the State of residence of the taxpayer does not recognise the right of the State of activity to tax but the State of activity taxes such remuneration. This would result in the State of residence refusing to grant a credit for the foreign taxes paid in the State of activity leading to double taxation: once in the State of activity and again in the State of residence. Such a double taxation could occur on account of:

- the State of residence and the State of activity using different methods for calculating the 183 day period;
- State of residence and the State of activity using the same method but affording a different interpretation to the same method;
- disparity in the interpretation of the phrase 'borne by a permanent establishment';
- State of residence being an exemption country, which exempts the foreign remuneration only if the taxpayer has been away for more than 183 days, etc.

Double non-taxation can arise where the State of residence exempts the income or considers that the same should be taxed

in the State of activity while the State of activity does not levy tax on such income. This issue of double non-taxation could be addressed by making the exemption by the State of activity a conditional exemption i.e. the State of activity would exempt the income only if the State of residence of the taxpayer taxes it.

90-DAY RULE UNDER THE IT-ACT

In the preceding paragraphs we have discussed the concept of dependent personal services in terms of a tax treaty situation. What happens if the foreign employer / employee does not belong to a country with which India has entered into a tax treaty? The answer lies in section 10(6)(vi) of the IT-Act which is popularly referred to as the 90-day rule. As per section 10(6)(vi), salary earned by an individual, not being a citizen of India, from a foreign employer for services rendered by him during his stay in India, is exempt from tax in India, provided:

- the foreign employer is not engaged in any trade or business in India;
- his stay in India does not exceed in aggregate a period of ninety days in the relevant previous year; and
- such remuneration is not liable to be deducted from the income of the employer chargeable under the IT-Act.

Here it would be pertinent to note that the exemption under section 10(6)(vi) of the IT-Act can be availed by any individual, who is not an Indian citizen, earning income from employment performed in India, whether such individual comes from a treaty country or otherwise.

While considering the interplay between section 10(6)(vi) and section 9(1) of the ITA, the Delhi High Court¹² held that amounts paid by the Government of India undertaking to foreign experts were not payments to the foreign concern for technical services, but rather, based on the

factual position, were payments to the two experts whose services were requisitioned while seeking guidance as well as consultation services. The High Court upheld the order of the Tribunal wherein the Tribunal had held that "section 10(6)(vi) does not require that there should be contract between the Indian company and the foreign experts and remuneration be paid directly by the former to the latter on the basis of the contract. It only requires that remuneration must have been received by the foreign expert as employee of the foreign concern for services rendered in India. The two experts were employees of the foreign concern, which was not carrying on any business activity in India. Their stay in the country was for seven days only. Whether the remuneration was directly paid to them by the assessee-company or it was received by them from their own concern is not material for the purpose of section 10(6)(vi)."

SERVICES RENDERED ABOARD A SHIP OR AIRCRAFT

Under Article 15 of the OECD Model Convention an exception is carved out for remuneration derived in respect of an employment exercised aboard a ship or aircraft operated in international traffic, or aboard a boat engaged in inland waterways transport. As per this exception, the remuneration may be taxed in the State in which the place of effective management of the enterprise is situated.

The Bombay High Court¹³ has recently ruled upon an interesting case wherein the tax authorities were contenting that a 'foreign going Indian ship' continued to remain territory of India by virtue of the provisions of the Merchant Shipping Act and thus service rendered by a non-resident on such a ship could be held to accrue and arise in India. The Bombay High Court, relying on its earlier

judgment¹⁴, ruled that section 2(25A) of the IT-Act that defines the term "India" does not cover foreign going Indian ships operating beyond Indian territorial waters for the purposes of determining whether services are rendered in India. Thus income earned by the non-resident in such a situation was considered to be income earned in foreign waters and thus to have accrued to him outside India. Accordingly, the same would not be chargeable to tax in India. The Court also held that the provisions of the Merchant Shipping Act couldn't be read into the provisions of the IT-Act. In arriving at its conclusion, the Court also placed reliance on Circular 586 dated November 28, 1990 issued by the Central Board of Direct Taxes.

EXPOSURE TO SERVICE PE

It should be noted that where a Convention provides for a Service PE due to the presence of employees of the enterprise of a Contracting State in India, where the services are rendered, employees falling within the ambit of Article 15 may also constitute a Service PE of their foreign employers in India.

CONCLUSION

In the times when "internationally mobile executive" is the norm of the day, applicability of Article 15 and its interpretation have assumed a great deal of importance. Further, in view of the changes proposed by the Finance Bill, 2003, in the status of Resident but Not Ordinarily Resident, expatriates would have exposure to dual residency. The worldwide income of such expatriates may become taxable in India and one would need to consider the interplay of Article 4(2) and Article 15 to address the issue of potential double taxation. Thus, it would be worthwhile for the companies deploying such expatriate employees in India to ascertain their taxability in India prior to their deputation in India.

**References:**

1. Please note all references to Articles in this paper are in relation to the OECD Model Convention, unless specified otherwise.
2. The Pocket Oxford Dictionary, <http://www.askoxford.com/dictionary/employ>, accessed on April 16, 2003.
3. Harman L.J. in *Mitchell and Edon V. Ross*, [1961] 40 TC 11, HL.
4. Klaus Vogel, *Klaus Vogel on Double Tax Convention*, 3rd Edn. [1997], 887.
5. *Model Tax Convention on Income and on Capital* - OECD Committee on Fiscal Affairs [2000], Volume 1, para 4, C(15)-2.
6. Published: December 8, 1986, re. US-UK tax treaty.
7. *Model Tax Convention on Income and on Capital* - OECD Committee on Fiscal Affairs [2000], Volume 1, para 5, C(15)-2-3.
8. 1956-1 C.B. 851.
9. Klaus Vogel, *Klaus Vogel on Double Tax Convention*, 3rd Edn. [1997], 900-1.
10. Discussion regarding the instances of permanent establishment is outside the scope of this paper and hence not elaborated upon.
11. *Model Tax Convention on Income and on Capital* - OECD Committee on Fiscal Affairs [2000], Volume 1, para 7, C(15) - 4.
12. *CIT v. Bharat Heavy Electricals* [2001] 252 ITR 218 (Del).
13. *CIT v. Avtar Singh Wadhwan* [2001] 247 ITR 260 (Bom).
14. *CIT v. Indo Oceanic Shipping Co. Ltd.* [2001] 165 CTR 404 (Bom).

