Deputation of employees abroad - Practical Issues and Experiences

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Synopsis

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Interpretation of DTAAs:

Double taxation avoidance agreements (**"DTAAs"**) are designed to promote mutual trade and investment between the countries that have entered into such agreements. They aim at ensuring that the same income is not taxed in both countries, in the hands of the same entity. The DTAA provides that a particular source of income can be taxed by Country A or by Country B, where Country A and B have entered into the DTAA. Or the DTAA can provide for sharing of the income for the purpose of tax levy between the two countries. India has entered into DTAAs with most of her trading partners. But for a proper interpretation of DTAAs it is also essential to understand the very concept of the DTAA and its applicability versus the domestic laws in each country.

DTAA Models:

One immediate object of DTAAs is to promote bilateral trade by the avoidance of double taxation of income. Over the years, several model tax treaties have been formulated by various governments/multilateral agencies. The three well-known models are the OECD Model, the UN Model and the US Model.

The UN Model is largely based on the OECD Model, the main difference being that the OECD Model gives importance to the right of the resident state (country where the tax payer is a tax resident) to tax the income. On the other hand, the UN Model gives importance to the source state (country from where the income is derived) to tax the income. The US Model has been published by the US Treasury Department.

Most of the DTAAs entered into by India with the developed countries of the world are largely based on the UN Model but those with OECD countries follow a mixture of OECD and UN

models. Thus, it is also important to keep abreast of the commentaries that are issued from time to time as regards treaty interpretation.

Overriding nature of DTAAs:

Under a DTAA, the Contracting States mutually undertake to respect and apply the DTAA provisions. This is one of the fundamental principles of law of DTAAs. Yet, it is essential to bear in mind that DTAAs may not always override domestic laws. The practice differs from country to country. It is important to understand what is the status of the DTAA under the domestic law and what is its relationship with the domestic law.

There are two approaches to this. Under the first approach, the countries treat both the International Law and the domestic law as part of the same legal system and give International Law[1] precedence over domestic law. Under the second approach, both the DTAAs and domestic laws are treated as separate legal systems and in case of a conflict; it is the domestic law, which is given priority by the domestic courts.

In the United Kingdom (**"UK"**), DTAAs form part of the UK law only to the extent to which they have been given effect through an act of Parliament. In Germany, international agreements have to be made effective through implementing legislation. In France, certain agreements can only form part of the domestic law, if legislation is specifically enacted adopting them into the domestic system. In the United States (**"US"**), DTAAs have equal status with domestic laws, but in practice the latter abrogates the earlier.

In India, section 90(2) of the Income-tax Act, 1961 ("**Act**") clearly provides that:

*"Where the Central Government has entered into an agreement with the Government of any country, outside India under sub-section (1) for granting relief of tax, or as the case may be, avoidance of double taxation, then, in relation to the assessee to whom such agreement applies, the provisions of this Act **shall** apply to the extent they are more beneficial to that assessee"*

In other words, there is clarity under Indian tax laws, that the provisions of the Act will apply only if they are more beneficial; else if a taxpayer is covered by the DTAA, it is the provisions of the DTAA that shall apply.

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[1] International Law mainly consists of International Agreements, Customary International Law and General Principles of Law. International Agreements take the form of DTAAs , Conventions, Covenants, Charters and the Act. The Vienna Convention on the Law of Treaties (1969 and 1986) mainly governs the law on treaties between countries and in relation to International Organizations. The Customary International Law emerges from the practice of each country.

Concept of a PE:

The issue of taxable presence and Permanent Establishment (**"PE"**) is among the foundation stones of international taxation. All the three Model Conventions use the concept of a PE as the main instrument to establish taxing jurisdiction over a foreigner's business activities.

To illustrate: If Company X which is a tax resident of Country A carries on operations in Country B, then Country B can tax the business profits of such company only to the extent they are attributed to a PE in Country B. In such a scenario, Country A, depending upon the provisions of DTAA entered into with Country B, will grant Company X either a tax exemption or a tax credit with respect to the income earned in Country B.

Under Article 5[2], paragraph 1, of the OECD Model Convention, a PE is defined as a fixed place of business through which the business of an enterprise is wholly or partly carried on. Under Article 7, paragraph 1, of the OECD Model Convention, a foreign taxpayer will be subject to income tax, if it carries on its business through a PE in the other Country.

Article 5, paragraph 2, includes a branch to be a PE. Thus, if an Indian company sets up business operations in Japan through a branch, then Japan, has the right to tax that portion of the profits of the Indian company that are attributed to the PE in Japan. A subsidiary, in general does not constitute a PE. However, if such subsidiary is regarded as a dependent agent of the parent company it would give rise to the existence of a PE in the other country.

This presentation paper does not purport to deal with the tax incidence in case of a branch or a subsidiary. It concentrates on those circumstances where deputation of employees by an Indian company to a foreign country could result in the existence of a PE of the Indian company in the foreign country. In such a scenario, the profits of the Indian company would be taxed in the foreign country to the extent to which they are attributed to such PE.

PE arising out of deputation of employees:

It is quite difficult to imagine that mere deputation of employees, without actually having a branch in the other country, or a wholly dependent subsidiary can result in the existence of a PE. But this could well happen.

In this context it is essential to carefully examine the following issues:

- Installation PE
- Service PE
- Dependent agent

[2] Article 5 of the OECD Model Convention that relates to the concept of a Permanent Establishment is attached as Annexure 1.

Each of these is dealt with below, together with suitable illustrations.

Installation PE:

As per Article 5, paragraph 3 of the OECD Model Convention*:*

"A building site or construction or installation project constitutes a Permanent Establishment only if it lasts for more than twelve months"

This clause has as its basis the "duration test". Thus, if the twelve month period for a building site, or construction or installation project, is exceeded a PE is deemed to exist from the beginning of the project. While the duration test applies to each project, if several contracts are inextricably interlinked, both geographically and commercially, the duration could be aggregated and a PE could be regarded as being in existence in a foreign country, even if each such project is based on different contractual agreements.

Case study 1

Company A is a Bangalore based software company. It has recently bagged an award to carry out the development and installation of customized software for a major bank in the Netherlands (Dutch Bank). Besides installation it will also carry out certain ancillary activities in Netherlands such as onsite testing of the software. The intellectual property in the software will also vest with the Dutch Bank. Will this result in the creation of an "installation PE" of Company A in the Netherlands?

Let us examine the provisions of the DTAA entered into between India and the Netherlands.

Article 5 (3) provides as follows:

"*A building site or construction, installation or assembly project constitutes a permanent establishment only where such site or project continues for a period of more than six months."*

Earlier the view was that installation projects could only be those relating to roads, bridges, canals and so on. But, tax authorities world over have kept pace with changing times. Installation of customized software is more than likely to fall within the provisions of Article 5(3) and if such installation project is carried on at the client's site for a period of more than six months, viz: at the premise of Dutch Bank in the Netherlands, Company A will have a PE in the Netherlands.

Netherlands will have the right to tax that portion of the profits of Company A that can be attributed to such PE in the Netherlands. In other words, the onsite profits of Company A to the extent to which they are attributed to such PE will be subject to tax in the Netherlands.

Service PE

The OECD Model Convention does not contain a service PE clause. Nonetheless, a few DTAAs entered into by India with other countries do incorporate this provision. By virtue of the existence of such a clause, if services are rendered through employees in the other country for a period more than the prescribed number of days a PE could be constituted.

For this purpose multiple counting of days is to be avoided. For example, if Mr. A and Mr. B are rendering services concurrently for the same period of 30 days for a particular project in Country C, the number of days which will be considered is 30 days and not 60 days. Moreover, for all practical purposes, if an employee has visited Country C, not for the purpose of rendering services, these days should not be taken into consideration in calculating the prescribed period.

Case study 2

Company B is a Hyderabad based company, which provides non-technical services to clients abroad. Two of its employees, Mr. X and Mr. Y will be deputed to Singapore to work for a period of 100 days during the year 2003. Consequently, will a "Service PE" of Company B exist in Singapore?

Let us examine the provisions of the DTAA entered into between India and Singapore. Article 5(6) provides as follows:

"An enterprise shall be deemed to have a Permanent Establishment in a Contracting State, if it furnishes services, other than services referred to in paragraphs 4[3] and 5[4] of this Article and technical services as defined in Article 12, within a Contracting State through employees or other personnel, but only if:

a) Activities of that nature continue within that Contracting State for a period or periods aggregating to more than 90 days in any fiscal year; or
b) Activities are performed for a related enterprise (within the meaning of Article 9 of this Agreement) for a period or periods aggregating to more than 30 days in any fiscal year

[3] An enterprise shall be deemed to have a permanent establishment in a Contracting State and to carry on business through that permanent establishment if it carries on supervisory activities in that Contracting State for a period of more than 183 days in any fiscal year in connection with a building site or construction, installation or assembly project which is being undertaken in that Contracting State

[4] Notwithstanding the provisions of paragraphs 3 and 4, an enterprise shall be deemed to have a permanent establishment in a Contracting State and to carry on business through that permanent establishment if it provides services or facilities in that Contracting State for a period of more than 183 days in any fiscal year in connection with the exploration, exploitation or extraction of mineral oils in that Contracting State

Thus, as the services rendered by Company B, in Singapore are **not** in the nature of technical services[5] and the services are rendered through its employees for a period aggregating to more than 90 days in a fiscal year, Company B will have a PE in Singapore.

Even if Mr. X and Mr. Y are not deputed to Singapore, but Company B, sub-contracts the work to Mr. T, then and the activities of Mr. T[6] are subject to detailed instructions and comprehensive control of Company B, then if Mr. T renders service in Singapore for a period of more than 90 days during 2003, Company B will have a service PE in Singapore.

Dependent agent

Article 5, paragraph 5 of the OECD Model Convention states as follows:

"Notwithstanding the provisions of paragraph 1 and 2, where a person other than an agent of an independent status to whom paragraph 6 applies is acting on behalf of an enterprise and has, and habitually exercises, in a contracting state an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a Permanent Establishment in that state in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a Permanent Establishment under the provisions of this paragraph."

Thus, to qualify as an agency PE, either (a) an agent or persons dependent on the enterprise or (b) an independent agent who is not acting in the ordinary course of his business must:

a) Act on behalf of the enterprise;
b) Must have the authority to conclude contracts in the name of the enterprise; and
c) Must exercise this authority on a habitual or ongoing (Not isolated) basis.

These contracts should relate to the core operations or essential and significant (not ancillary) business activities of the enterprise.

The issue of whether or not a dependent agency PE is created arises in situations where third parties act on behalf of the company in another country. Employees generally are regarded as dependent agents, unless it can be proved that such an employee is an independent agent.

For a dependent agency PE to exist in the other country, it is essential that a dependent agent must have acted on behalf of the enterprise and the act of such agent should be binding on the enterprise. It is vital that the dependent agent has the authority to actually conclude binding contracts in the name of the enterprise. Mere solicitation of business or negotiation of a contract, where the enterprise has the right to reject the negotiations entered into by the agent does not result in an agency PE. However, in this context, it is also

[5] To determine whether services can be construed as technical services or not, Article 12 of the DTAA between India and Singapore needs to be interpreted carefully as also the interpretation of this Article by tax authorities in Singapore
[6] Mr. T will not be an independent agent as defined under the DTAA. Commentary on Article 5 of the Oecd Model Convention.

essential to look at the interpretation of this term by tax authorities in the other country. For example, in Denmark, PE issues could arise if the agent does not disclose to the customer that the agent is not entitled to sign any contracts. It is also essential that the dependent agent exercises the authority to conclude such contracts "habitually". It should be exercised repeatedly and not just on an odd occasion.

In certain circumstances, even a subsidiary of a company in another country could be regarded as a dependent agent. Thus the profits of the company to the extent to which they can be attributed to such subsidiary can be subject to tax in the other country.

Case study 3:

This case study deals with a decision by the Italian court (Italian Corte Suprema di Cassazione) in the case of Ministry of Finance vs Philip Morris dated March 7, 2002.

The court gave two rulings, one in relation to direct taxes and the other in relation to VAT. In these rulings, the court has laid down five principles for determining PE.

These rulings have the effect of widening the PE concept, especially in relation to multinational group structures, which may have within its fold a hidden PE entity.

Philip Morris GmbH ("**PMG Co"**), a German resident company, had entered into distribution agreements with the Italian state monopoly ("**AAMS**") for the sale of cigarettes in Italy. Under the agreements, the PMG Co could appoint a representative in Italy to visit warehouses and sales outlets and accordingly it appointed Intertaba Spa ("**IS Co**").

Under the agreement between PMG Co and AAMS, IS Co was not allowed to perform any marketing or sales activities. IS Co received a fee for its activities as a representative of PMG Co. It also rendered similar services to other foreign companies selling cigarettes in Italy.

PMG Co was assessed to direct taxes as well as VAT, by the Italian tax administration on the contention that IS Co constituted a PE of the PMG Co due to its role in the negotiations between PMG Co and AAMS. All the profits from the sale of cigarettes to Italy were attributed to this PE.

PMG Co won before the second level court that it did not have a PE in Italy and the case then came up as appeal. The Supreme Court of Italy laid down five principles for determining whether a PE exists and remanded the case back to the lower court to compute the tax liability by applying these principles.

The legal principles established by the Supreme Court are as under:

1. A company, which is resident in Italy, may take the role of being the permanent establishment of several foreign companies that belong to the same group and that pursue the same or a similar strategy. In such a case – according to the

Italian Supreme Court, in order to ascertain whether an activity carried out by a domestic company is auxiliary or preparatory, reference must be made to the program of the whole group;

2. The monitoring of a contract is not auxiliary in character;
3. The participation of representatives or offices of a national structure to a phase of the conclusion of contracts between a non-resident company and other resident persons falls within the concept of "authority to conclude contracts in the name of the enterprise" also in cases where the representatives do not have any formal negotiation power
4. When a non-resident company entrusts the management functions to a resident company, even if it concerns a certain area of operations, this gives rise to the acquisition of a PE;
5. The verification of requisites of the PE, including the ones on dependence and participation in the conclusion of contracts, must be conducted from a substantial and not from a formal standpoint.

In its observations, the Supreme Court stressed on the aspect that the IS Co transactions with PMG Co and other group companies, had been so structured as to avoid IS Co being regarded as a PE in Italy.

While the determination of existence of a PE in the source country is a fact driven exercise and no strait-jacket formula can be evolved for such determination, the Philip Morris ruling has widened the gamut for such determination.

Conclusion:

Before deputing employees to a foreign country, or before assigning any activities to be carried on by a third party in a foreign country, it is essential to examine the possibility of such events creating a PE in the other country.

(The contents of this paper should not be construed as legal opinion or professional advice).

Annexure 1

PE as per Article 5 of the OECD Model Convention

1. For the purpose of this Convention, the term "Permanent Establishment" means a fixed place of business, through which the business of an enterprise is wholly or partly carried on
2. The term "Permanent Establishment" includes especially:
    a) a place of management;
    b) a branch;
    c) an office;
    d) a factory;
    e) a workshop; and
    f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources
3. A building site or construction or installation project constitutes a Permanent Establishment only if it lasts for more than twelve months *(Installation PE)*
4. Notwithstanding the preceding provisions of this Article, the term "Permanent Establishment" shall be deemed not to include:
    a) The use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
    b) The maintenance of stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
    c) The maintenance of stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise
    d) The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or collecting information for the enterprise;
    e) The maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary nature;
    f) The maintenance of a fixed place of business solely for any combination of activities, mentioned in sub-paragraphs 'a to e' provided that the overall activity of the fixed place of business resulting from this combination is of preparatory or auxiliary character.
5. Notwithstanding the provisions of paragraph 1 and 2, where a person other than an agent of an independent status to whom paragraph 6 applies is acting on behalf of an enterprise and has, and habitually exercises, in a contracting state an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a Permanent Establishment in that state in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a Permanent Establishment under the provisions of this paragraph

6. An enterprise shall not be deemed to have Permanent Establishment in a contracting state merely because it carries on business in that state through a broker, general commission agent or any other agent of an independent status provided that such persons are acting in the ordinary course of their business
7. The fact that a company which is a resident of a contracting state controls or is controlled by a company which is a resident of the other contracting state, or which carries on business in that other state (whether through a Permanent Establishment or otherwise) shall not of itself constitute either company a Permanent Establishment of the other