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International Tax

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Delhi ITAT holds actual physical presence and not virtual presence is required for construction of service PE in India in terms of India- Singapore DTAA

Snapshot

Delhi Tribunal held that actual performance of service in India is essential for constituting service PE in India as per India-Singapore DTAA. The actual physical presence of employees in India shall be considered for computing period for which services were furnished in India for determining service PE.

The Tribunal discussed that in the absence of concept of virtual service PE in India-Singapore DTAA, no virtual service PE can be constituted in India unless treaty provisions are amended. It further held that for calculating number of days for determining service PE, vacation days, business development days and common days to be excluded.

Facts of the Case

Taxpayer¹ was a Singapore tax resident and was governed by the provisions of India-Singapore DTAA. It was engaged in providing legal advisory services to several international clients including Indian clients. For AY 2020-21 taxpayer's employees provided service to Indian clients both virtually as well few employees travelled to India for providing the said services. For AY 2021-22, services were entirely rendered from outside India. For both the assessment years' the taxpayer claimed the service income from India as exempt on account of absence of permanent establishment ('PE') in India since it did not have any fixed base in India as well as physical presence of employees in India was less than 90 days. Assessing Officer disallowed the claim of the taxpayer and held that it had a service PE in India for both the assessment years based on physical or virtual presence. While calculating physical presence in India, the Assessing Officer considered the total number of man days spent by employees in India including vacation and business development days. In relation to virtual presence for constituting service PE, the Assessing Officer relied on Para 6 of Article 5 of India-Singapore DTAA and held that the aggregate duration of provision of service by a non-resident is important and not the physical presence to provide that service. Furthermore, the Assessing Officer added income from bank and interest on income tax refund to the income of the taxpayer based on information available in form 26AS. The taxpayer alleged that it had not received any such amounts in the subject assessment year. The taxpayer dissatisfied by the order preferred an appeal to the Tribunal.

¹. Clifford Chance PTE Ltd. Vs. ACIT [ITA Nos. 2681 & 3377/Del/2023]

Taxpayer's Arguments

The taxpayer argued that the physical stay of employees in India in AY 2020-21 was 44 days which was less than 90 days limit as provided in Article 5(6)(a) of India-Singapore DTAA. Accordingly, service PE should not be constituted in India for the said assessment year.

Further, for AY 2021-22 since there was no physical presence of any employee for provision of services in India, no service PE would be constituted in India. The taxpayer relied on the decision of **Hon'ble Supreme Court in the case of ADIT vs. E-Funds IT Solution Inc. 86 taxmann.com 240 (SC)** and argued that for the purpose of furnishing of service in source state there should be actual performance of service in source state.

Two employees travelled in India in AY 2020-21 for rendition of services. The taxpayer while calculating the days of stay of employees in India excluded vacation days, business development ('BD') days and common days relying on the judgement of **Hon'ble Mumbai Tribunal in the case of Linklaters LLP vs. DDIT 106 taxmann.com 195 (Mumbai-Trib).**

The taxpayer further contended that in the 35 days spent for BD, the employees had undertaken activities like identification of customers, technical presentation/providing information to prospective customers, developing market opportunities, making quotations to customers etc. wherein no element of furnishing of service was involved and they were non-revenue generating activities. Accordingly, they should be excluded for computation of threshold limit of 90 days.

Regarding exclusion of common days, the taxpayer relied on the judgement of **Linklaters LLP (supra) and Clifford Chance v. United Kingdom [2002] 82 ITD 106 (Mum.)** to argue that stay of employees on a particular date to be taken cumulatively and not

based on independent man days for calculating threshold limit.

Further, in relation to revenue's arguments for creation of virtual PE, the taxpayer argued that as per Article 5(6)(a) of India-Singapore DTAA, furnishing of services within the source state meant actual performance of services in the source state. It further placed reliance on the OECD commentary.

Taxpayer further stated that if the view taken by the revenue were to be applied then virtually all foreign entities rendering services to Indian customers from overseas would result in constituting service PE in India which would be absurd and illogical.

Revenue's Arguments

The revenue argued that the taxpayer constituted virtual service PE in India in both the covered assessment years. Revenue argued that there was no mandate in the tax treaty that the employees providing services within India must be stationed in India and services provided from outside India were also to be considered for constitution of service PE in India.

The Revenue authorities relied on the decision of Bengaluru Tribunal in the case **ABB FZ LLC 83 taxman.com 86 and OECD Interim Report 2018** under the OECD/G20 BEPS Project Titled "Tax challenges arising from Digitalization" which focuses on the context of virtual service PE.

Decision of Delhi ITAT

The Hon'ble Delhi ITAT referred to the provisions of service PE as provided in Article 5(6) of India-Singapore DTAA and held that the following provisions needs to be satisfied cumulatively for constitution of service PE in India:

- Employees of foreign entity **should be present** in India;

- There should be **furnishing of services** (other than services referred to paragraphs 4 and 5² of Article 5 and technical services as defined in Article 12³) **within India** through employees or foreign entity; and
- Activities of that nature i.e., **such furnishing of services should continue for a period exceeding 90 days in a fiscal year** (relevant AY) or 30 days when such services are rendered to related enterprises.

The Hon'ble ITAT held that to constitute service PE in India, **"actual performance of service in India is essential."** Accordingly, services rendered by employees with their **physical presence in India shall be taken in to account for computing threshold limit of 90 days** (since the services were rendered to an independent Indian client). It further relied on the decision of the Hon'ble Supreme Court in the case of E-Funds IT Solution (*supra*) to hold that for constituting service PE, services must be furnished within India.

Further, in relation to calculation of number of days for determining physical presence for constituting service PE, the Hon'ble Tribunal relied on the decision of Linklaters LLP (*supra*) and Clifford Chance (*supra*) and excluded vacation days, BD days and common days for calculating threshold for service PE. Accordingly, it accepted the taxpayer's proposition that physical presence in India for calculating threshold for service PE amounted to 44 days which was less than threshold of 90 days for AY 2020-21.

Furthermore, in relation to reliance placed by Revenue on ABB FZ LLC (*supra*) and OECD report (*supra*), the Tribunal distinguished the judgement of Bengaluru Tribunal with the taxpayer's case on the grounds that the said case was rendered in context of FTS and in absence of FTS article in India-UAE DTAA, taxability of the same under Article 7 of DTAA was analyzed which was not the case of the taxpayer.

In relation to the reliance placed on OECD report, the Hon'ble Tribunal held that the concept of 'Virtual Service PE' had been officially endorsed in Saudi Arabia but not in India. Further it also discussed that it is mentioned in the report that in absence of any amendments to treaty provisions, the said view could be challenged before courts. It accordingly held that the taxpayer did not constitute a virtual service PE in India since there were no provisions regarding establishment of virtual service PE under India-Singapore DTAA. It accordingly held that neither in AY 2020-21 nor in AY 2021-22 did the taxpayer constitute a service PE / virtual service PE in India.

In relation to the matter of interest from bank and interest on income tax refund, the Hon'ble ITAT held that income additions solely based on the fact that such amounts were appearing in form 26AS when no payment had actually been received in relevant years was not sustainable in law and hence liable to be deleted.

KCM Comments

It appears that the reliance placed by the Revenue on the judgement of **ABB FZ LLC 83 taxman.com 86 (Bang)** and the judgement of ABB FZ LLC differentiated by Hon'ble Delhi Tribunal (seems to be **ABB FZ LLC 75 taxmann.com 83 (Bang)**) are two separate judgements rendered in the case of same taxpayer in different years. The latter one differentiated by Delhi Tribunal does not discuss about service PE. It seems an inadvertent error by Revenue in producing judgement copy.

With the growing digital business worldwide and many countries adopting the approach of taxing digital transactions, this judgement is a welcome step in the direction of providing some relief to foreign taxpayers' providing services online without physical presence in India where India has a DTAA with the resident country.

² Paragraph 4 of Article 5 of India-Singapore DTAA discusses construction PE and Paragraph 5 of Article 5 of India-Singapore DTAA includes within its ambit PE formed due to services provided in relation to exploration, exploitation, or extraction of mineral oils in source state.

³ Article 12 of India – Singapore DTAA - Royalties and Fees for Technical Services

With the advent of SEP provisions in India, any services provided by any non-resident to any person in India, exceeding INR 20 million would constitute business connection in India and render the services as taxable under the Indian Income Tax Act. The only relief available to non-residents post SEP provision was under DTAA's (*if available*) since the DTAA's in most cases have not yet been amended to include virtual / digital presence under the ambit of permanent establishment. There is a high possibility of the revenue authorities taking similar arguments for constituting virtual service PE in India where post SEP provisions the benefit of DTAA has been claimed by the taxpayers.

Similar to the concept of 'Virtual Service PE' discussed by the Hon'ble Delhi Tribunal in the current case, the Hon'ble Mumbai Tribunal had in a recent judgement discussed the concept of 'Intangible Business Connection' in case of services performed overseas. The Hon'ble Mumbai Tribunal in the case of **Volkswagen Finance Pvt Ltd [TS-172-ITAT-2020(Mum)]** while deciding on an issue of business connection in India for a non-resident celebrity doing a performance in Dubai for an event held by an Indian company when all the benefits to the company making the payment for the said event accrued in India, held that the business connection in India was intangible in as much as it was a relationship rather than an object, but it was a significant business connection which had resulted in income accruing and arising to the non-resident, but for which there would not have been any business expediency in making the impugned payment to the non-resident celebrity. It accordingly held that the payment to non-resident celebrity by the Indian company was on account of business connection in India and taxable under section 9(1)(i) of the Act. The ITAT while deciding the issue under India-US DTAA took note of Article 23(3) (*Other income*) and held that the treaty protection from source taxation is not available for an income which is not covered by the specific articles of the treaty in question.

In relation to DTAA's, the interpretation of the words "furnishing of services within India" has still not attained finality since Bengaluru Tribunal in the case of ABB FZ LLC (*supra*) has discussed a different view regarding taxability of virtual service transactions. Furthermore, authority for advance rulings in the case of **MasterCard Asia Pacific Pte. Ltd. [2018] 94 taxmann.com 195 (AAR - New Delhi)** had placed reliance upon the decision of E-Funds IT Solution (*supra*) to hold that since the service was provided to Indian customers, the test for creating service PE was satisfied where the threshold of 90 days was achieved. In the said case, there was no detailed discussion on physical service days vis-à-vis virtual service days, however the fact that AAR held that service PE was formed in case services were provided to Indian customers may be relied upon by the Revenue authorities in future assessments. It is important to note that the interpretation of supreme court judgement by AAR to hold that services being provided to Indian customers would constitute service PE is very debatable since the supreme court in the judgement of E-funds(*supra*) had discussed that to constitute service PE services should be rendered "within India." In the said judgement, the customers were located outside India and hence the supreme court held that since the services had been received outside India, the condition of service PE was not satisfied. However, the question that "furnishing services in India" means "performance of services within India" or "receipt of services within India" is still debatable. Para 42.31 of OECD commentary as discussed in the judgement of E-funds(*supra*) has specified that services should be performed in a state by a foreign enterprise through an individual present in that state. Accordingly, any interpretation which suggests that services provided from outside India to Indian residents would constitute service PE in India without any consequent amendments in DTAA's would lead to undue hardships to foreign service providers.

The OECD interim report 2018 has discussed about 'Virtual Service PE' and has provided that the same has

been endorsed in Saudi Arabia. It is worthwhile to note that in 2015, through internal guidelines, Saudi Arabia introduced concept of 'Virtual Service PE' pursuant to which any work or services performed under cross-border agreements by non-resident in Saudi Arabia for a period longer than the tax treaty threshold (e.g., 183 days) will create a service PE for the non-resident, even if employees/contractors of the former are not physically present in the Saudi Arabia for such period and perform their activities entirely offshore. The authorities of Saudi Arabia formally confirmed the said view *vide* an official letter in 2016. However, it is imperative to note that in 2023, the Saudi Arabian government has again issued a circular clarifying its position that physical presence in Saudi Arabia for provision of services would be required to create a service PE where Double Taxation Agreements are signed with foreign jurisdictions.

Italian government in 2018 modified definition of PE in its domestic law whereby a foreign entity's significant and continuous economic presence in Italy may constitute a fixed base that could give rise to a permanent establishment in Italy even if it does not result in a substantial physical presence.

As per certain news and articles in public domain there are other countries evaluating on modifying traditional PE concept and introducing deemed PE in case of significant economic presence in source state. With the digital taxation debate picking momentum worldwide it would be interesting to see India's take on various positions and possibilities.

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