

New OECD definition of PE cheers foreign outsourcers

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BANGALORE: Will outsourcing work to India result in the creation of a "permanent establishment" in India and thus risk of exposure to Indian taxes? This is a question that is being asked by almost each and every foreign company which is examining outsourcing as an option.

A recent draft "proposed clarification of the permanent establishment definition, released by the Organisation for Economic Co-operation and Development (OECD) has ushered in greater clarity as to what constitutes a permanent establishment (PE).

The term PE is important because a country (say India) cannot tax the business profits of the resident of another country (say the United States), unless the latter has a PE in India.

OECD periodically revises the commentaries to its model OECD tax convention so as to keep it contemporary. As Indian tax authorities do refer to OECD commentaries while interpreting the nuances of tax treaties, the commentaries assume significance. This revised draft is currently open for public comments.

In the BPO scenario, a PE generally arises on two grounds, owing to the existence of a fixed place of business, or due to the existence of a dependent agent.

OECD's recent revised draft has explained both these issues. Mr Nitin Karve, partner, Bharat S Raut and Co, states: "The public discussion draft provides a number of answers that were implicit in the earlier commentary. OECD has now expanded various scenarios through concrete illustrations, which will aid interpretation."

OECD's working group has clarified that "where a company, that is a member of a multinational group provides services to another company of the same group, as a part of its own business, carried on in premises that are not those of that other company and using its own personnel, then in such instances, this place cannot be a PE of the company to whom the services are provided".

In other words, if ABC-India, which is part of a multinational group provides services to ABC Inc based in United States, but such services are part of the business of ABC-India, the services are carried on in the premises of ABC-India and through its own employees, this does not lead to the creation of a fixed-place PE in India of ABC Inc.

An agency PE arises if an entity habitually exercises the power to conclude contracts on behalf of the foreign enterprise. OECD's revised draft offers certain additional clarifications. It states: "The mere fact that a person has attended or even participated in negotiations between an enterprise and a client will not be sufficient, by itself, to conclude that the person has exercised in that country, an authority to conclude contracts in the name of an enterprise."

OECD calls for determining whether or not activities are preparatory and auxiliary in nature for determining whether or not a PE can be said to exist. Once a PE exists, either owing to a fixed place of business, or a dependent agent, if the transaction is at arm's length, no further profits can be attributed to the PE.

"The proposed changes in the commentary to the PE definition clarify that only when the subsidiary is carrying on parent's non-auxiliary (or core) business and has an authority to conclude contracts on behalf of the parent, will it constitute a PE," states Ms Shefali Goradia, head-international taxation, Nishith Desai Associates.

As per the circular issued by the Central Board of Direct Taxes (CBDT), reported earlier by ET, if a foreign company outsources the whole or part of its 'core revenue' generating business to an IT-enabled entity in India, then a 'considerable portion of the profits' derived by the foreign company from its customers abroad, would be attributable to the activities performed in India.

Further, if this entity in India, constitutes the PE of the foreign company, profits would be taxed in the hands of the foreign company.

In other words, the CBDT sought to determine the tax incidence in the hands of the PE, based on the nature of activities.

Till date, there remains considerable uncertainty regarding the mechanism whereby a 'considerable portion of profits' would be attributed to activities in India.

Yet, for now, OECD's revised draft certainly provides more clarity, as to when a permanent establishment can be said to exist in India.