Tax Hotline

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REMUNERATION PAID TO EXPATRIATE HELD AS "BORNE BY PE " WHEN PE TAXED ON PRESUMPTIVE TAX SCHEME

In a significant decision by the Authority for Advance Rulings ("**AAR**"), in the case of DHV consultants BV, it was held that remuneration paid by the foreign employer to its employee for services rendered in India to the Indian Project Office ("**PO**"), would be taxable in India.

The applicant, DHV Consultants ("**Dutch BV/applicant**"), a foreign company incorporated in the Netherlands, is engaged in the business of providing consultancy services in the areas of highways, transportation, water supply and waste water, urban development, environment, agricultural, natural resources, etc. It has set up several projects offices to carry out its activities in India. The POs constitute permanent establishment ("**PE**") of the Dutch BV in India under Article 5 of the tax treaty between India and the Netherlands ("**tax treaty**"). The income derived by the Dutch BV from these activities are taxed as fees for technical services accruing to its PE, on a presumptive basis under section 44D and section 115A of the Indian Income Tax Act, 1961 ("**ITA**"). It should be noted that section 44 D is no longer applicable in case of agreements entered into after March 31, 2003. However, this ruling is important for the purposes of the analysis of presumptive scheme of taxation. The Dutch BV sends its employees from the Netherlands to the Indian POs to work on various projects being executed by it in India. While in India, the employees continue to receive salary and allowances in their home country. Under the ITA, the Dutch BV is obligated to deduct Indian taxes at source in respect of salary taxable in India. As the employees are residents of the Netherlands, the applicant sought exemption from tax in India under Article 15 of the tax treaty. This article exempts salary from tax in India if all of the following conditions are satisfied:

a) The total duration of the stay of the employee in aggregate in India does not exceed 183 days in a tax year;
b) The remuneration for services rendered by the employee is paid by, or on behalf of, an employer who is not a resident of India : and
c) The remuneration is not borne by a PE or fixed base, which the employer has in India.

The applicant approached the AAR to determine whether condition (c) is satisfied when the Dutch BV is taxed in India based on the presumptive tax provisions of section 44D and 115A of the ITA.

The applicant argued as follows:

- As the applicant (Dutch BV) is liable to tax as prescribed under Section 115A and 44D on its gross receipts, none of the expenses incurred by it for its Indian operations are deductible in computing the taxable profits in India;
- Therefore, the remuneration paid to its employees in India cannot be treated as being borne by the PE or the applicant in India and, hence the condition under Article 15(2) (c) of tax treaty is satisfied;
- And hence, remuneration paid to employees in India would be exempt from tax in India.

The AAR did not agree with this reasoning. They examined the specific import of the terms "**borne by**" and deemed "**deductions**" in the presumptive taxation scheme. They referred to various case law and the fundamental accounting standards followed in India and abroad for computing taxable income. In the AAR's view, the expression "borne by" in sub-clause(c) of clause 2 of Article 15, means "deductible" or "liable to be deducted", similar to the use of the words in Section 10(6) under the ITA. As the term "borne by" is not defined in the tax treaty the AAR applied the meaning that it has under the ITA. Accordingly, they held that the remuneration would be a deductible expense. They took the view that the presumptive taxation scheme such as the one under section 44D of the ITA is brought on to the statute book to simplify the computation of income and enhance tax compliance and is an accepted method of taxation in tax jurisprudence the world over. However, such scheme only provides alternative computation of tax on royalty and fees for technical services. The scheme dispenses with the normally applicable provisions of computation of income under sections 28 to section 44C,as it prescribes a specified rate of income-tax payable by a foreign company i.e at 30 per cent on royalty and fees for technical services received for agreement entered into on or before May 31, 1997 and 20 per cent for agreement entered into after May 31, 1997. As against this scheme, rates of tax on a non-resident company for other income are much higher, e.g., 40 per cent for the assessment year 2004-2005. The AAR concluded that the lower rate of tax under section 115A is clearly due to the fact that tax on such income is computed on gross basis whereas in case of other income (other than royalty and fees for technical services) of a foreign company, tax is computed on net basis. The lower rate of tax prescribed under section 115A is clearly with a view to allowing margin for the deduction of expenses which include remuneration paid to employees working in India.

The AAR maintained that while computing taxable income of a PE, all proper outgoings have to be allowed as deductions to the extent permitted under the ITA. Thus, the salaries paid to the employees and all revenue expenses

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incurred for running the PE would have to be taken into account in determining the PE's profits in India and the same would be deemed to have been treated as deductible in the scheme of sections 44D and 115A. Any attempt to treat gross receipts of technical fees as income without deducting expenses connected therewith would run counter to the basic principle of accountancy as well as provisions of tax laws and tax treaties.

The AAR answered the applicant's question in the negative. They ruled that the condition specified under sub-clause (c) of clause 2 of article 15 of the tax treaty relates to the taxability of employees and not of the applicant and is therefore not relevant when the Dutch B.V. is taxed in India on presumptive basis under section 44D and section 115A of the ITA.

Interestingly, before parting, the AAR referred to the two international commentators, Dr. Phillip Baker and Dr. Klaus Vogel with respect to their interpretation on what constitutes "borne by" as used in sub clause (c) of clause 2 of Article 15 of the OECD model convention. Dr. Baker has stated that, the fact that the employer has, or has not, actually claimed a deduction for the remuneration in computing the profits attributable to the PE is not necessarily conclusive, since the proper test is whether any deduction otherwise available for that remuneration would be allocated to the PE. The test would be met even if no amount was actually deducted as the PE was exempt from tax in the source country or employer simply deciding not to claim deduction to which he was entitled.

Dr. Klaus Vogel has commented that the condition laid down in Article 15(2) (c) would be satisfied and the remuneration would be taxed in the state of residence if the PE in the source state bears the remuneration but where, by virtue of Article 8 (income from shipping, inland waterways transport and air transport), the PE's profits are not taxed in the source state. The reason is that in this case, the deduction of the remuneration as business expense does not adversely affect the tax revenue of the source state.

This is a very important ruling in applying the provisions of Article 15 of the tax treaties. It should be noted that advance ruling is only binding in case of the applicant who has applied for it, though it may have persuasive value in determining taxability in respect of similar transactions.

-Nithya Reddy & Daksha Baxi

Source: In re DHV Consultants BV [2005] 147 TAXMAN 521 (AAR-NEW DELHI)

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