

FPI and PE funds – unintended tax consequences of COVID 19

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1. Introduction

1.1 The pandemic, COVID-19 has made the global economy come to a standstill. As countries globally began enforcing strict lockdowns to prevent the spread of the coronavirus, India, the world's second-most populous country, followed the suit too. Due to the lockdown, a situation has arisen where managers of Foreign Portfolio investments and Private equity funds based in Mauritius or Singapore temporarily away from home country and are stranded in the host country (India). This occurrence has led to tax consequences for FPIs and PE funds.

2. Tax consequences for FPIs and PEs

2.1 Any services provided by a manager of a FPI and PE funds may give rise to a Permanent Establishment in the host country if the services are provided beyond 90 days in any 12 months (India- Mauritius DTAA). In the case of Singapore DTAA, service PE is established if the employee stays 90 days or more in a fiscal year, and the said period is reduced to 30 days when services are performed for Associates Enterprises. Therefore, a fund manager resident of Singapore is struck in India for more than 30 days could potentially create Service permanent establishment for the FPI / PE fund in India. Interestingly, the number of such personnel is not important as even two persons on deputation can constitute a PE.

2.2 In the present age of technology, where the services can be provided through various virtual modes (e.g., email, internet, video conference, remote access to a desktop), the physical presence of the foreign taxpayer's employees in the host country is not relevant for determining the existence of a Service P.E. (ABB FZ-LLC v. Deputy Commr. of Income-tax (International Taxation), [2017] 83 taxmann.com 86). However, during the lockdown period, the Employee of foreign entity renders services including managerial services in India (not taxable as royalty or FTS) and satisfies the threshold period as mentioned above, then the service PE is inadvertently created in India.

2.3 Such a literal interpretation could lead to far-reaching implications on the global business operations of Multinational Enterprises operating in multiple jurisdictions. In the case of FPIs and PEs

2.3.1 These employees expose their foreign entities (employer) to the risk of taxation in India, by way of constituting Service Permanent Establishment of that foreign funds in India, per the relevant DTAs;

2.3.2 These key managerial persons taking decisions concerning the foreign employer while their stay in India, could result in forming the place of effective management of those foreign entities in India. Consequently, they become tax residents in India thereby global income needs to be reported in India. The phone calls made by them or mails sent by them could establish the fact pattern that decisions are taken in India.

2.4 The existing taxation regime under the Income-tax Act or the DTAs entered into by India does not address these unprecedented issues. It is thus likely that under the existing position of law, many genuine taxpayers including foreign entities may be burdened with tax liabilities and compliances, which most certainly, is undesirable when India intends to attract investments into India. In these circumstances, the Government must provide relief to the taxpayer from unintended consequences emanating from lockdown.

- a) An individual who is not a resident of India, should not create a service PE in India by simply staying in India for some weeks or months because of lockdown announced by the Government if he usually lives outside India, intends to return to his home country as soon as he can. Individuals return ticket, VISA, hotel booking confirmations generally provide insight into the intention of the entity sending such persons to India.
- b) Normally when an individual becomes a tax resident of both home and host countries, Tie-breaker rules provided in tax-treaties help to determine which country has the right to tax an individual as the country of residence. A similar concept may be introduced for providing relief in the case of service PE for the FY 2020-21. The officer may examine the following criteria to come to a conclusion the employee

stranded in India due to lockdown indeed intended to return to his home country before the specified time.

- Where a permanent home is maintained.
- Where employment duties are performed.
- Where the individual's family resides.
- Where the individual is registered with the local authorities.
- Where bank accounts and other assets are maintained.

If the officer opines that employee intended to return before the specified time if the lockdown was not announced then the days spent in India during lockdown must be reduced from the threshold days provided in Art 5 (6) of the DTAA to determine the creation of service PE in India:

c) The Government may even consider extending the threshold days provided in the DTAA by lockdown period incorporating a beneficial provision in the domestic act for the FY 2020-21.

2.5 It is important for the Non-resident managers of FPI / PE funds staying in India to maintain detailed documentation viz return ticket, hotel bookings, etc setting out the intention of the parties to be able to mitigate Service PE exposure.

2.6 The OECD in its analysis has also mentioned that the COVID-19 situation shall not create any changes to a PE determination. The exceptional and temporary change of the location where employees exercise their employment because of the COVID-19 crisis, such as working from home, should not create new PEs for the employer. It has urged the tax administrations to provide guidance to minimise or eliminate unduly burdensome compliance requirements for taxpayers in the context of the COVID-19 crisis. It has added that during the COVID-19 crisis, individuals who stay at home to work remotely are typically doing so as a result of government directives. It is a force majeure, not an enterprise's requirement.

3. Residential status of FPIs

3.1. Yet another unintended consequence for FPIs and PEs from lockdown that needs to be addressed is the creation of Place of Effective Management in India. Foreign

companies are said to be a resident in India in any previous year if its Place of Effective Management ('POEM'), in that year, is in India. The guidelines dt 24th Jan 2017 (Circular no 06 of 2017) laid down for determination for POEM specifies certain conditions when a foreign company is said to have 'active business outside India'. In case of FPI Funds, the active business is not considered to be outside India as it does not satisfy the cumulative criteria laid down in para 5 of the guidelines, which amongst other includes that such foreign company shall not have more than 50% of its total worldwide assets in India.

3.2. In the case of a foreign company, who does not have an active business outside India, POEM is determined in two stages –

- The first stage would be identification or ascertaining the person or persons who make the key management and commercial decision for the conduct of the company's business as a whole.
- The second stage would be a determination of place where these decisions are being made.

3.3. Para 8.3 of the Guidelines mention that if the POEM cannot be determined in accordance with the above, which could be due to decisions being taken in multiple countries then the following secondary factors can be considered:

- Place where the main and substantial activity of the company is carried out; or
- Place where the accounting records of the company are kept.

For determination of POEM, Substance is more conclusive than the Form.

3.4. The provision of the determination of the residential status of foreign entities, other than foreign companies, are more rigorous. These entities are considered to be residents of India except where control and management of its affairs, during the year, is situated wholly outside India. The term 'control and management' has not explicitly been defined under the Income-tax Act.

- 3.5. The above provisions relating to the determination of the residential status of foreign entities are expected to severely affect those Foreign Portfolio Investment Funds and Private Equity Funds situated in foreign countries if their directors or personnel, who take their key managerial decisions, have been stranded in India amidst the COVID-19 outbreak since in such case there is an inevitable risk of the entities being considered as resident of India as their 'key managerial decisions' and 'control and management' are not completely outside India.
- 3.6. It is thus, recommended that in light of the present epidemic situation, the decisions taken by these individuals in the capacity of key managerial persons or controller or manager of any foreign entity, while they are stranded in India due to exceptional circumstances like quarantine, travel restrictions, closure of international borders in consequence of COVID-19, shall not be considered to have been taken in India.
- 3.7. However, to ensure that the above relaxation is granted only to the genuine taxpayers, it shall not apply in cases where these foreign entities are residents of India in the immediately preceding year, on account of 'key managerial decisions' taken in India or their 'control and management' not being wholly outside India.
- 3.8. The OECD in its report has stated that a temporary change in location of the chief executive officers and other senior executives is an extraordinary and temporary situation due to the COVID-19 crisis and such change of location should not trigger a change in residency. It has an emphasis on the 'usual' and 'ordinary' place of effective management.

4. Conclusion

The unprecedented challenges call for an unprecedented solution. Doing the same thing and expecting a different result is insanity. Changes suggested above if brought in quickly will alleviate the problem of FPIs and PE funds from unintended tax liability arising on account of Service PE and POEM.
