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Tax Issues for Foreign Law Firms Entering India

Analysis

A recent Indian tribunal's ruling provides clarity on when a foreign law firm is considered to have a virtual PE in India, but potential tax issues may still riddle foreign law firms entering India, say Nishith Desai Associates practitioners.

The Indian legal services industry is witnessing a paradigm shift as the government has recently lifted its restrictions on foreign law firms from operating in India. While this change is currently limited to permitting advice on foreign law aspects, it opens the floodgates for various legal and tax issues with regards to the presence of foreign law firms in India (particularly in light of the general position adopted by the Indian revenue authorities assessing the income of such foreign law firms to tax in India).

In this context, while the transience begs us to ponder upon several legal questions, a recent judgment of the Income Tax Appellate Tribunal in *Clifford Chance PTE Ltd. vs ACIT* ([2024] 160 taxmann.com 424 (Delhi ITAT)) delivers some certainty in terms of taxability in India when rendering legal services in India from overseas.

The Delhi bench of the Income Tax Appellate Tribunal ("Tribunal") ruled that legal advisory services rendered by Clifford Chance (a foreign law firm incorporated in Singapore — "Taxpayer") to Indian clients, from outside India, should not result in a (virtual) services permanent establishment ("PE") in India. It was held that the presence of the Taxpayer's employees, temporarily in India during visits, did not meet the requisite 90-day threshold for the formation of a services PE under Article 5(6)(a) of the *India-Singapore Tax Treaty* ("Singapore Treaty"). Mosty importantly, the Tribunal opined that since the treaty specifically provides for the criterion of physical presence in India as requisite, a 'virtual' services PE could not be read into the scope of Article 5(6)(a) of the Singapore Treaty (in the absence of specific language to such effect).

Whilst there were other issues on appeal before the Tribunal, such as the validity of the revenue order and attribution of profits to the services PE, this article will restrict the discussion to the concept of a 'virtual' services PE (and related issues while foreign law firms render services in India).

Case Background

The Taxpayer, being an international law firm, provides legal advisory services across the globe (including to clients in India). Notably, the Taxpayer did not have any physical offices or premises in India; and rendered services to Indian clients either entirely remotely from outside India (as is the case for one of the tax years under dispute), or through employees visiting India for a limited number of days (for the purpose of rendering such services).

Interestingly, however, the employees of the Taxpayer were also in India for business development activities (in the nature of identifying and presenting to potential clients, developing market opportunities, and providing quotations), which was otherwise not connected to the services it was rendering in India. To this extent, the Tribunal also shed light on whether time spent on such activities in India could be counted to meet the threshold number of days (i.e., more than 90 days) required for constituting a service PE.

Tribunal Ruling

Article 5(6)(a) of the Singapore Treaty deems the formation of a PE in India if: a) a Singapore resident entity renders services in India through its employees or other personnel; and b) such activities continue within India for a period of 90 days or more. The Tribunal ruled in favor of the Taxpayer to conclude that the Taxpayer did not constitute a services PE in India, and accordingly, no profits could be attributed to, and taxed in India.

Agreeing with the Taxpayer, the Tribunal relied on the Supreme Court's ruling in *E-Funds* (*ADIT vs. E-Funds IT Solution Inc.*, [2017] 86 taxmann.com 240 (SC)), to conclude that the services must be furnished within India, for a service PE to be constituted (making the actual performance of services in India paramount for this determination). Accordingly, as the services were not physically rendered in India, a virtual services PE could not be artificially read into the language of the existing Article 5 (to create a services PE in India). In this regard, the revenue had placed reliance on a Bangalore Tribunal's decision in *ABB FZ LLC* (*ABB FZ-LLC v. ITO*, [2017] 162 ITD 89 (Bangalore Trib.), and the explanation in the *OECD interim report on digitalization*, (which notes the views expressed by certain countries that physical presence is no longer required for entities to render their services in other countries; and accordingly, should not be a requisite to constitute a service PE) (OECD (2018), *Tax Challenges Arising from Digitalisation — Interim Report 2018: Inclusive Framework on BEPS*). However, the Tribunal observed from the same *Interim Report*, that in the absence of amendments to the language of treaty provisions to expressly include this view, the concept of a virtual services PE was bound to be challenged by taxpayers. Having ruled the absence of a PE in India, the Tribunal considered the attribution of the profits to India to be an academic question which it did not delve into.

Ruling Analysis

The Tribunal's ruling (aptly) confirms that days spent conducting business development activities (or vacationing) should not be counted towards meeting the 90-day threshold day count under the treaty. The Tribunal's exclusion of business development activities from the scope of services PE is a welcome clarification (especially in light of increasingly globalized service models). Further, clarity with respect to double counting of overlapping days (i.e., common days spent in India between the two employees should be counted only once for the purposes of the threshold) is relevant for larger law firms with varied practices, where different employees may be traveling to India at different points in time through the year. The rationale is that the test under Article 5(6)(a) refers to the cumulative presence of the enterprise (i.e. the Taxpayer) in India, and not the presence of each and every employee of the Taxpayer (separately). The ruling should offer a sense of comfort to several such overseas businesses (operating in a hyper globalized world where flexible working is increasingly becoming the norm; and employees may regularly travel to India for personal or business development purposes).

The Tribunal further reiterated the principle that language which is not explicitly included in treaty provisions cannot be artificially read into such provisions by way of a judicial fiction. The Tribunal explicitly notes that an amendment to the existing language of Article 5 would be required in order for a 'virtual' services PE to be constituted in India. This is broadly in alignment with the principles outlined in previous rulings of the Tax Tribunals and High Courts. In *Blackstone*, the tribunal held that the concept of 'beneficial ownership' cannot be artificially read into Article 13, in the absence of specific language to this effect (*Blackstone Capital Partners (Singapore) VI FDI Three Pte Ltd vs ACIT, [2023] 452 ITR 111 (Delhi)*). However, given that the ruling of Blackstone is currently sub-judice before the Supreme Court, the judgment of the apex court with respect to this principle (i.e., a literal vs purposive interpretation of treaty provisions), is highly anticipated.

Another possible risk arises when a foreign law firm sets up its own office in India. While the distinction on what can and cannot be done by the foreign law firms in India has been drawn in the relevant legislations, contentious situations may nonetheless arise where overseas lawyers assist their Indian counterparts in rendering legal advisory services on the same mandates (during their limited visits to India). It may become harder in such instances to distinguish between the role performed by the visiting foreign lawyers and the lawyers employed by the Indian office. While the existence of a branch office in India may be considered as a permanent establishment by the tax authorities, The analysis of income attribution to such a PE will need to be conducted on a case-by-case basis (i.e., based on specific facts and activities undertaken in India).

While enhancing the jurisprudence on foreign law firms potentially constituting a PE in India, this judgement serves as a guiding tool, to provide for circumstances in which a PE of such foreign firms should *not* be formed in India (*Linklaters LLP v. ACIT*, [2023] 150 taxmann.com 15 (Mumbai - Trib.)).

It is also relevant to consider the potential characterization (under relevant tax treaties with India) of the foreign law firm's income. Tax treaties allocate (and restrict) taxing rights over different streams of income to one or both contracting states to a tax treaty. Accordingly, whether payments to a foreign law firm (such as payments from its office/branch in India to the headquarters) constitute fees for technical services ("FTS"), and thereby attract withholding tax obligations in India remains pertinent. Whilst there is plethora of case law supporting the fact that legal services should not constitute FTS, in the absence of any explicit legislation or a Supreme Court ruling, it remains to be an open point of consideration *Linklaters LLP v. ACIT*, [2023] 150 taxmann.com 15 (Mumbai - Trib.); Infosys BPO Ltd. v. DCIT, [2021] 131 taxmann.com 293 (Bangalore - Trib.); Linklaters Singapore (Pte.) Ltd. v. DCIT, [2019] 101 taxmann.com 486 (Mumbai - Trib.); Ershisanye Construction Group India (P.) Ltd. v. DCIT, [2017] 84 taxmann.com 108 (Kolkata - Trib.)). Similarly, certain tax treaties have specific rules on the treatment of income from Independent Personal Services. Owing to the nature of services rendered by law firms, the application of the aforementioned rule may also merit consideration (Linklaters LLP v. Dy. CIT (International Taxation) [2018] 172 ITD 459 (Mum. - Trib.)).

Further, the very applicability of the tax treaty (and whether a foreign law firm may avail the benefit of a tax treaty) also merits some thought. For instance, for law firms constituted as partnerships (as is the case for many law firms globally), the firm may not qualify as a 'person', depending on the language of the relevant tax treaty. This is because of its fiscally transparent nature. In such a scenario, the partners (or any person having an interest in the firm) would need to be considered for the purpose of the tax treaty application.

Various complexities arise here, such as: (a) the determination of the law firms' form is a question of treatment under the domestic law of the foreign country, (b) partners of the law firm may be based in different jurisdictions (and not just the country in which the firm is headquartered) leading to problems in applying relevant tax treaties, (c) partners of the law firm may be residents of jurisdictions with which India may not have a tax treaty in force leading to non-availability of any tax treaty benefit, and (d) there may be a higher risk of scrutiny of the entirety of the partners' income in India. From a domestic law standpoint, in the absence of such partnerships being able to avail a tax residency certificate from their resident jurisdiction, taxes may need to be withheld at higher rates while remitting money from India (Section 206AA of the Income Tax Act, read with Rule 37BB of the Income Tax Rules).

Thus, while the judgment of the Tribunal provides a semblance of certainty in how the courts in India would view the business activities of law firms in India, various issues (as set out above) remain untested before the courts and may lead to potential litigation in the coming future.

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