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A comparative analysis of the income tax provisions applied to outsourced services to South Africa and India

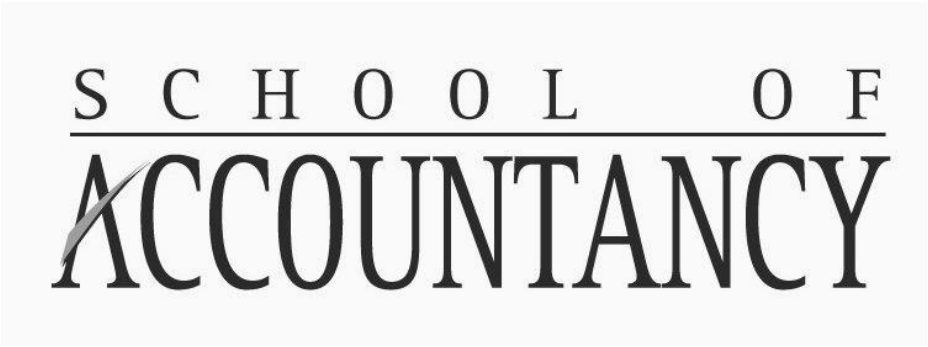
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University of the Witwatersrand, Johannesburg

A COMPARATIVE ANALYSIS OF THE INCOME TAX PROVISIONS APPLIED TO OUTSOURCED SERVICES TO SOUTH AFRICA AND INDIA

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A research report submitted to the Faculty of Commerce, Law and Management, University of the Witwatersrand, Johannesburg, in fulfilment of the requirements for the degree of Master of Commerce (Specialising in Taxation)

Johannesburg, 2017

ABSTRACT

This report discusses how the outsourcing of services results in the creation of a service permanent establishment for a non-resident entity. The tax consequences that result from a service permanent establishment in South Africa and India, as the outsourced destinations, will be compared against each other.

To remain globally competitive and to provide the best quality of work to clients, entities may decide to outsource services through a secondment arrangement or through a subcontracting arrangement, each having different tax implications. The parties must clearly indicate the type of arrangement in a contractual agreement, as an entity could create a service permanent establishment in a foreign jurisdiction.

Non-resident entities often outsource services to organisations in South Africa and India. This report provides a comparative analysis of the income tax provisions applicable to a resident and a non-resident for both a company and individual in South Africa and India. It further analyses income tax provisions related to the definitions related to residency, for a company and an individual in terms of the Income Tax Act 58 of 1962 in South Africa and the Income-tax Act, 1961 in India. Other provisions compared in this report include the tax rates, rebates and thresholds in terms of such legislation.

Key Words: Non-resident, Resident, Corporate income tax, Personal income tax, South Africa, India, subcontracting, secondment, OECD *Model Tax Convention*, Double Tax Agreements and Permanent Establishment.

DECLARATION

I declare that this research report is my own unaided work. It is submitted for the degree of Master of Commerce (specialising in Taxation), at the University of the Witwatersrand, Johannesburg. It has not been submitted before for any other degree or examination at any other university.

_____

Sandhya Janti Parshotam

18 April 2017

DEDICATION

I would like to acknowledge and extend my sincere gratitude to the following:

- God Almighty for blessing me with strength and perseverance;
- My loving family for their support, sacrifice, encouragement and patience;
- My friends and colleagues for their faith and motivation; and
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KEY TERMS AND ABBREVIATIONS

Abbreviation	***Meaning***
BRICS	Brazil, Russia, India, China and South Africa
OECD	Organisation for Economic Co-operation and Development
R	South African Rand
Rs.	Indian Rupee
SARS	South African Revenue Service
The Act	Income Tax Act 58 of 1962
UK	United Kingdom
US or USA	United States of America
USD or $	US Dollar

CHAPTER 1: INTRODUCTION

1.1 Background

In business, it is important to choose the correct 'outsourcing destination' as well as the types of functions to be outsourced. Outsourcing destinations may be required to provide added 'value, performance and innovation' to companies. (Deloitte, 2016b:3.) As a result, a non-resident entity may decide to outsource services to entities in other jurisdictions (Bakhru & Gupta, (2012)). The following are various reasons for entities to outsource work to other entities (Deloitte, 2016a:6):

- 'Cost cutting tool;
- Enables focus on core business functions;
- Solves capability issues;
- Enhances service quality;
- Critical to the business needs;
- Access to intellectual capital;
- Manages business environments; and
- Drives broader transformational change.'

Successful outsourcing destinations have a 'talent pool' that make them 'attractive globally' (Deloitte, 2015:4, 8). The report is from a South African perspective and South Africa has been identified as a good 'outsourcing destination' (Deloitte, 2016b:3). India has also proven over the years to be an ideal outsourcing destination (Deloitte, 2015:6). For these reasons, South Africa and India were identified to be the comparative countries in this research report. Neither South Africa nor India is a member of the Organisation for Economic Co-operation and Development (OECD) (OECD, (n.d.)). Even though South Africa is not a member of the OECD, its double tax agreements are structured on the OECD model (Brincker, 2001:17-19). South Africa and India have the following traits in common:

- Members of the G20 nations (G20, (n.d.));
- Members of BRICS (Brazil, Russia, India, China and South Africa) (BRICS, (n.d.));

- Members of the Commonwealth of Nations (Commonwealth of Nations, (2017));
- Members of the United Nations (United Nations, (n.d.)); and
- Classified as Developing countries (The World Bank, (n.d.)).

South Africa is perceived as the 'gateway to other African countries' (Deloitte, 2015:3). It has an upcoming skilled resource base which can be outsourced to other international countries to render services in the accounting or actuarial space (Deloitte, 2015:8, 12). Johannesburg, Cape Town and Durban, are three South African cities that rank at 20, 56 and 100 respectively in the *Tholons Top 100 Outsourcing Destinations 2016* (Tholons, (2016)).

India has experienced enviable economic growth over recent years and is considered as a market for cheap skilled resources and so companies have chosen to either establish businesses there or outsource work to India (Bakhru & Gupta, (2012)). India ranks as the number one outsourcing destination according to the *2016 A.T. Kearney Global Services Location Index* (A.T. Kearney, (2016)). In addition, six of the top ten outsourcing destination cities are in India according to the *Tholons Top 100 Outsourcing Destinations 2016* (Tholons, (2016)).

The following table published in the Deloitte outsourcing reports show the reasons for services being outsourced to South Africa (Deloitte, 2016b:3) and India (Deloitte, 2015:6) respectively:

South Africa	*India*
• Cost	• Large English speaking talent pool
• Culture and accent	• Sustained quality
• Government support	• Presence of skilled IT expertise
• Infrastructure	• Domain expertise across functions
• Risk profile	• Price-competitiveness
• Time zone	• Improved process efficiencies
• Labour quality	• Higher customer satisfaction

This report discusses two ways by which outsourcing can occur: a secondment arrangement and a subcontracting arrangement. The commentaries provided on Article 5, 7 and 15 in the OECD *Model Tax Convention on Income and on Capital: Full Version 2014* (*Model Tax*

Convention) will be referred to when examining a service permanent establishment, business profits and the characteristics surrounding a secondment arrangement and a subcontracting arrangement.

A secondment arrangement occurs whereby a resource performs the 'business activities' of his 'formal employer' but is actually provided to another entity who:

> 'bears the responsibility or risk for the results produced'

by that resource (OECD, 2014:C(15)-16). The resource works under the 'supervision and control' of the latter (Bakhru & Gupta, (2012)) who is seen to be the 'economic employer' of that resource (Taxand, (2012)).

For the purposes of this report, a subcontracting arrangement denotes an arrangement entered into by a contractor and sub-contractor, each in different countries, for the provision of services to a client over a prescribed period. The sub-contractor is responsible for its work to the contractor who in turn is responsible for it to the client. Resources of the contractor or sub-contractor may be required to travel outside their home jurisdiction to perform services for a certain period of time.

The duration that a resource is present in a foreign jurisdiction for work purposes can also have significant effects in terms of creating a service permanent establishment (OECD, 2014:C(15)-7-8) (Morrison, Reilly & West, (2009)). It is important to understand the concept of a permanent establishment in respect of its meaning and application (Bakhru & Gupta, (2012)). The meaning provided in double tax agreements between countries must be read in conjunction with how countries treat permanent establishments in terms of their domestic legislation, (Bakhru & Gupta, (2012)). It determines the right of the jurisdiction where services are rendered to tax business profits of a non-resident entity (OECD, 2014:C(7)-1-4). Business profits would be taxable in a jurisdiction if the non-resident has a permanent establishment and the profits are attributable to that permanent establishment (OECD, 2014:C(7)-1-4), (Bakhru & Gupta, (2012)). Once a permanent establishment exists in the jurisdiction where services are rendered, the non-resident entity may be liable for tax in that country The country's specific legislation governs the basis on which taxes are levied at the applicable rate for a non-resident entity. (Morrison, Reilly & West, (2009).) The provisions in the income tax legislation of South Africa and India are discussed in the report to determine the tax liability of a non-resident entity in these outsourcing destinations.

The research also aims to provide a comparative analysis into specific income tax provisions for corporates and individuals from a South African and Indian perspective. In terms of South African tax legislation, certain definitions examined in terms of s 1 of the Income Tax Act 58 of 1962, hereafter referred to as the Act; include for example the definitions of a resident, company and gross income. The tax rates, rebates and thresholds applicable in South Africa will also be examined (SARS, (2017a)), (SARS, (2017c)).

In terms of Indian tax legislation, the definition of a resident is examined under s 6 of the Income-tax Act, 1961. Other definitions include for example a company, person and total income under s 2 of the Income-tax Act, 1961. The tax rates, rebate and thresholds applicable in India will be examined (Income Tax Department, (2017a)). Over the years, there were several Indian court cases that involved non-resident entities creating a permanent establishment through an outsourcing arrangement (Ashley, (2013)). Two Indian cases, *Centrica India Offshore (P.) Ltd. v. CIT* [2014] 364 ITR 336 and; *DIT (IT) v. Morgan Stanley & Co.* [2007] 292 ITR 416 (SC) are discussed in this report.

1.2 The Research Problem

1.2.1 Research Question

How do the direct income tax requirements of South Africa and India compare if a non-resident entity were to create a service permanent establishment through the outsourcing of services in each country?

The research report will thus examine how outsourcing services, either through a secondment arrangement or subcontracting arrangement, can create a service permanent establishment for a non-resident entity. South Africa and India have been identified as prime outsourced destinations (Deloitte, 2015:4). A comparative analysis of the corporate tax requirements resulting from the creation of a service permanent establishment from the outsourcing arrangement, will be done between these two countries. A comparative analysis of the individual tax requirements in respect of resources sent to work in South Africa and India will be done.

1.2.2 The Sub-Questions

In order to answer the main research question the following sub-questions will be addressed:

1.2.2.1 What is meant by a non-resident entity? This is explained in terms of South African and Indian requirements as the report is based on a comparative analysis of certain tax legislation of these countries. In order to determine what a non-resident is, the definition of a resident must first be examined in terms of s 1 of the Act, and s 6 of the Income-tax Act, 1961.

1.2.2.2 What are the various ways in which services can be outsourced between entities in different jurisdictions? A contract will indicate whether the contracting parties have entered into a secondment arrangement or subcontracting arrangement.

1.2.2.3 How does the type of outsourced services create a service permanent establishment for a non-resident entity? This question will first examine the meaning of a permanent establishment. According to the commentaries provided on Article 5(1) in the *Model Tax Convention*, a permanent establishment (OECD, 2014:C (5)-1 - 2) is defined as a:

> 'fixed place of business, through which the business of an enterprise is wholly or partly carried on.'

The question will also answer how the non-resident could create a service permanent establishment (OECD, 2014:C(5)-31 - 32). The type of arrangement (secondment or subcontracting) entered into by a non-resident entity, could result in a permanent establishment (Ashley, (2013)), (Morrison, Reilly & West, (2009)).

1.2.2.4 What are the South African income tax provisions applying to a resident and non-resident for corporates and individuals for outsourcing arrangements? The question will examine certain income tax provisions applicable to direct taxes for corporates and individuals. This sub-question will address the applicable tax rates for the 2017 year of assessment and tax thresholds (SARS, (2017a)), (SARS, (2017c)) as well as certain provisions of the Act. In terms of s 1, the following definitions will be examined: company, gross income, permanent establishment, taxable income and year of assessment. Section 5(1) and s 5(2) of the Act provide for the levy of tax and the tax

rates will be examined. Section 6(2) (*a*), (*b*) and (*c*) of the Act provide the various tax rebates that are applicable to a natural person, will be analysed. South African legislation provides for tax thresholds which are defined under paragraph 1 of the Fourth Schedule of the Act, will be examined.

1.2.2.5 What are the Indian income tax provisions applying to a resident and non-resident for corporates and individuals for outsourcing arrangements? The question will discuss certain provisions applicable to direct taxes for corporates and individuals. This sub-question will address the applicable tax rates and tax thresholds for the 2016-2017 financial year (Income Tax Department, (2017a)) as well as certain provisions of the Income-tax Act, 1961. Under s 2 of the Income-tax Act, 1961, the definitions of an assessment year, company, person and total income will be examined. Section 3 provides the definition of previous year (the financial year immediately preceding the assessment year), which will be analysed. The basis to charge tax at a tax rate, as provided in s 4, will be examined. The scope of total income for a resident and non-resident, found in s 5(1) and s 5(2) respectively, will be examined. Non-resident entities will be taxed on income in India if there is a business connection in India. The concept of a business connection which will be examined is found in s 9(1)(*i*). (Nishith Desai Associates, 2003:18.) The tax rebate which will also be analysed is found in s 87A.

1.2.2.6 How does the South African income tax legislation compare to Indian income tax legislation that applies to outsourcing arrangements? This sub-question will analyse those tax provisions that were previously examined to determine those which are similar and different between South Africa and India. An analysis will be conducted on how a company and individual in India are taxed as they are subjected to different rates depending on residency (Income Tax Department, (2017a)). A comparison will be conducted into how a non-resident company and individual are taxed in South Africa (SARS, (2017a)), (SARS, (2017c)) and India (Income Tax Department, (2017a)) according to the relevant tax rates.

1.3 Research Methodology

The research is qualitative in nature. The primary sources to be analysed include the OECD material, journal articles and case law.

Additional source material includes the income tax legislation of South Africa and India. Country specific legislation will be examined to analyse the definition of residency, income and assessment period in each country. The tax rates applicable to companies and individuals depending on their residency will be examined.

The following will fall outside the scope of this report and will not be examined: paragraphs in Article 5 other than those relating to a permanent establishment and service permanent establishment, source of income, exemptions, deductions, Pay As You Earn, transfer pricing, the inter-relationship between a business connection and a permanent establishment in terms of Indian tax legislation and factors other than tax that will impact on a decision on where to locate outsourced services.

CHAPTER 2: COUNTRY SPECIFIC RESIDENCY CONCEPTS

2.1 Background

Non-resident entities receive services being performed on their behalf from entities based in South Africa (Deloitte, 2016b:6) and India (Deloitte, 2015:6). The report will analyse the term non-resident by referring to country specific legislation. To determine what a non-resident is from the perspective of South African and Indian income tax legislation and applicable case law, the definition of a resident must firstly be examined for a company and natural person or individual. If a person does not comply with the definition of a resident, then that person is deemed a non-resident. The definition of a resident is found in s 1 of the Act and s 6 of the Income-tax Act, 1961 respectively.

2.2 South Africa

2.2.1 Resident – Company

For a company to be a resident in South Africa, it must comply with para (b) of the definition in s 1 of the Act. The two criteria that must be met for a company are:

- that it is incorporated, established or formed in the Republic; or
- has its place of effective management in the Republic.

Place of effective management is not defined in the Act and to understand the term, guidance is provided in the South African Revenue Service (SARS) *Interpretation Note: 6 (Issue 2) - Resident – Place of Effective Management (Companies)* of 3 November 2015 (*Interpretation Note 6)*. The meaning of a company's place of effective management (SARS, 2015:4) is:

> 'the place where key management and commercial decisions that are necessary for the conduct of its business as a whole are in *substance* made.'

This approach is in-line with that taken by the OECD (SARS, 2015:4, 5). In terms of *Interpretation Note 6*, a company can have more than one place of management but can only

have one place of effective management at a time. The key management and commercial decisions of a company can be made at more than one place and if so, the place:

> 'where those decisions are primarily or predominantly made'

is regarded as the company's place of effective management. (SARS, 2015:5, 6.)

Operational management does not contribute in determining the place of effective management of a company (SARS, 2015:11). This entails (SARS, 2015:12) the:

> 'oversight of the day-to-day business operations and activities of a company.'

The following factors are also not relevant in determining the place of effective management (SARS, 2015:12, 13):

- company's place of incorporation, formation or establishment;
- location of its registered office;
- location of its public officer;
- company's economic nexus with a country; and
- location where a company's accounting records are retained.

2.2.2 Resident - Natural person

For a natural person to be a resident in South Africa, the person must comply with para (*a*) of the definition in s 1 of the Act. This defines a natural person to be a resident as follows:

- ordinarily resident in the Republic; or
- physically present in the Republic—
    - for more than 91 days in aggregate during the relevant year of assessment;
    - as well as more than 91 days in aggregate during each of the five years of assessment preceding the current year of assessment; and
    - more than 915 days in aggregate during those five preceding years of assessment;

where in such an instance that person will be a resident from the first day of that relevant year of assessment.

The term ordinarily resident is not defined in the Act. Case law is considered for guidance to interpret the term ordinarily resident. In terms of the SARS *Income Tax Interpretation Note No 3: Resident: Definition In Relation To A Natural Person – Ordinarily Resident* of 4 February 2002 (*Interpretation Note 3)*, there are two court cases that provide an explanation of the term ordinarily resident (SARS, 2002:2):

- *Cohen v CIR* [1946] 13 SATC 362
- *CIR v Kuttel* [1992] 54 SATC 298

Cohen v CIR, establishes that a person can be resident in more than one country but can only be ordinarily resident in one country at a time (Clegg and Stretch, 2016:para. 8.3.1). The country where a natural person is ordinarily resident (SARS, 2002:2) would mean:

> 'the country to which a person would naturally and as a matter of course return from his/her wanderings.'

CIR v Kuttel, establishes that a person can only have 'one real home.' A person's real home would be the place where his 'usual or principal residence' is. (Clegg and Stretch, 2016:para. 8.3.1.) Even if a person makes 'temporary/occasional' (SARS, 2002:3) visits on 'a regular basis' to a country (Clegg and Stretch, 2016:para. 8.3.1), that person cannot be considered to be ordinarily resident of that country (Clegg and Stretch, 2016:para. 8.3.1).

2.2.3 Non-resident

The term non-resident is not explicitly defined in the Act. If a company or natural person does not meet the requirements set out in the definitions above, that person is a non-resident for income tax purposes in South Africa. The following two criteria may also deem a person a non-resident of South Africa for income tax purposes.

Firstly, in terms of proviso (B) of para (*a*)(ii) of the definition of a resident in s 1, if a person who is a resident in terms of the physical presence test is physically outside South Africa for a continuous period of at least 330 full days, that person will be deemed to be a non-resident. The continuous period starts a day after the day that person physically left South Africa (SARS, 2012:12). Secondly, in terms of the definition of a resident in s 1, any person (company and natural person) that is deemed to be exclusively a resident of another country in terms of a

double tax agreement between the government of South Africa and the government of the other country, will be deemed to be a non-resident of South Africa (SARS, 2012:9, 10).

2.3 India

2.3.1 Resident - Company

The definition and requirements for a company to be a resident in India are stated under s 6(3) of the Income-tax Act, 1961. The criteria that deem a company to be a resident in India are that:

- it is an Indian company; or
- its place of effective management, in that year, is in India.

From the definition of a resident company, it can be established that an Indian company will always be classified as a resident in India (Income Tax Department, (2017b)). Initially, the second requirement of s 6(3) read that:

> 'the control and management of the company's affairs is situated wholly in India.'

Therefore, if the control and management of a company's affairs was situated wholly or partly outside India, that company would be deemed to be a non-resident (Income Tax Department, (2017b)). In terms of Circular No. 06 of 2017, companies abused the second requirement by 'shifting insignificant or isolated events related with control and management outside India.' To disallow companies from avoiding the residency requirements and being removed from the tax net, the requirements needed to change. (Government of India, 2017:1.)

With effect from 1 April 2017, the second requirement was changed to being the place of effective management of a company (Government of India, 2017:1), (Income Tax Department, (2017b)). The change in the wording of the legislation will apply as indicated from the effective date, to the 2017-18 assessment year as well as subsequent assessment years (Government of India, 2017:1). Under s 6(3) of the Income-tax Act, 1961 an explanation is provided for the second criterion by stating that the 'place of effective management' means:

> 'a place where key management and commercial decisions that are necessary for the conduct of business of an entity as a whole are, in substance made.'

The place of effective management concept is internationally recognised and this change aligns India with international standards (Government of India, 2017:1). In terms of Circular No. 06 of 2017, the place of effective management is a 'substance over form' concept. Further, the Circular indicates that an entity can only have one place of effective management at any point in time, but can have more than one place of management. A company's place of effective management is to be determined on an annual basis since a residency test is done on an annual basis. (Government of India, 2017:3.)

Another important factor in determining the place of effective management is whether a company 'is engaged in active business outside India' (Government of India, 2017:3). The place of effective management for a company (Government of India, 2017:3):

> 'engaged in active business outside India shall be presumed to be outside India if the majority meetings of the board of directors of the company are held outside India.'

The board of directors of a company can be based outside India but they can choose not to exercise their powers. As a result, the powers can be exercised by the holding company or other person resident in India, in which case the place of effective management is considered to be in India. (Government of India, 2017:3.)

In instances where a company is not engaged in an active business outside India, the criteria to determine the place of effective management differs. The process in determining the place of effective management is to identify who is responsible for making the:

> 'key management and commercial decisions'

and the place where these decisions are made. The place where these decisions are made are more important than the place where these decisions are implemented. The substance is therefore, more significant than the form. (Government of India, 2017:4.)

2.3.2 Resident – Individual

For an individual to be taxed in India, the tax residency status of the individual needs to be determined (PwC, (2017b)). The following types of residency status exist for an individual (PwC, (2017b)), (KPMG, (2016)):

- Resident and Ordinarily Resident in India;
- Resident but Not Ordinarily Resident in India; and

- Non-Resident in India.

The definition of a resident individual is provided in s 6(1) of the Income-tax Act, 1961 which indicates that an individual is deemed to be a resident in India in any previous year (KPMG, (2016)), if he:

- is in India in that year for a period or periods amounting in all to 182 days or more; or
- during the four years preceding that year been in India for a period or periods amounting in all to 365 days or more, is in India for a period or periods amounting in all to 60 days or more in that year.

The second requirement cannot be taken into consideration in certain cases (Income Tax Department, (2017b)). If the following conditions exist, the first requirement for residency is relied upon (Income Tax Department, (2017b)):

- If an Indian citizen leaves India during the previous year for the purpose of employment outside India;
- If an Indian citizen leaves India during the previous year as a member of the crew of an Indian ship; or
- If an Indian citizen or a person of Indian origin comes on a visit to India during the previous year.

Section 6(6) of the Income-tax Act, 1961 defines a person to be 'not ordinarily resident' in India in any previous year (KPMG, (2016)), if such person is:

- an individual who has been a non-resident in India in nine out of the ten previous years preceding that year, or
- has during the seven previous years preceding that year been in India for a period of, or periods amounting in all to, 729 days or less.

Therefore, an individual that complies with either requirement of s 6(1) of the Income-tax Act, 1961 will be considered a resident. Thereafter, if that individual does not comply with both requirements of s 6(6) of the Income-tax Act, 1961, that individual is deemed to be a Resident and Ordinarily Resident in India (KPMG, (2016).) If that individual, however, complies with either requirement of s 6(6) of the Income-tax Act, 1961, that individual is deemed a Resident but Not Ordinarily Resident in India (KPMG, (2016)).

2.3.3. Non-resident

Section 2(30) of the Income-tax Act, 1961 defines a non-resident of India as a person that is not a resident. A non-resident is one that does not comply with the definitions found in s 6(3) for a company and s 6(1) for an individual and includes a person who is a Resident but Not Ordinarily Resident defined in terms of s 6(6) of the Income-tax Act, 1961.

2.4 Entity

For the purposes of this report, the outsourcing arrangement will be from the perspective of an entity. The term 'entity' is defined in the *Merriam-Webster Dictionary* as, 'an organisation (as a business or governmental unit) that has an identity separate from those of its members.'

2.5 Conclusion

For a company to be a resident in South Africa it must be incorporated, established or formed in South Africa or have its place of effective management in South Africa in terms of para (b) of the definition of a resident in s 1 of the Act. For a natural person, that person must either be ordinarily resident in South Africa or comply with the physical presence test in terms of para (*a*) of the definition of a resident in s 1 of the Act.

If a company and natural person does not comply with their respective requirements it will be deemed a non-resident. Also, if that company and natural person is exclusively a resident of another country in terms of a double tax agreement between South Africa and that other country, it will be deemed a non-resident (SARS, 2012:9, 10).

For a company to be a resident in India it must either be an Indian company or have its place of effective management in India in terms of s 6(3) of the Income-tax Act, 1961. For an individual, that person must comply with s 6(1) and not s 6(6) of the Income-tax Act, 1961 to be deemed a Resident and Ordinarily Resident in India. To be deemed a Resident but Not Ordinarily Resident in India, an individual must comply with s 6(1) and either requirement of s 6(6).

If a company and individual does not comply with their respective requirements it will be deemed a non-resident in terms of s 2(30) of the Income-tax Act, 1961. The following chapter will discuss the nature of a secondment arrangement and a subcontracting arrangement that a non-resident entity can enter into.

CHAPTER 3: NATURE OF OUTSOURCED SERVICES

3.1 Background

There are various ways in which services can be outsourced between entities in different jurisdictions, each creating various tax consequences. The way in which services are outsourced is stated in the contractual arrangement between the relevant parties (Ashley, (2013)). This chapter discusses the way in which services can be outsourced through a secondment arrangement and a subcontracting arrangement. The descriptions of a secondment arrangement and a subcontracting arrangement have been provided in chapter 1.1.

3.2 Explanation of secondment arrangement and subcontracting arrangement

A secondment arrangement involves at least three parties contractually. To differentiate between the contracting parties, they are referred to as the following (Krishnamurthy, (2015)), (Taxand, (2012)):

- the entity based in the home or resident country, also referred to as the sending entity or the formal employer;
- the person who will provide the service in the host country, known as the resource, individual, secondee or employee; and
- the entity that receives the services based in the host country, also known as the receiving entity. Depending on the contract this entity may be the economic employer.

The term 'second' is defined in the *Collins English Dictionary* as being sent:

> 'temporarily by your employer in order to do special duties.'

One party to a secondment arrangement is the resource or the secondee. The term 'secondee' is defined in the *Collins English Dictionary* as, 'a person who is seconded.'

The concept of seconding resources between entities in a group is not an unfamiliar arrangement (Ashley, (2013)). Secondment arrangements generally have the following characteristics (Krishnamurthy, (2015)), (Bakhru & Gupta, (2012)):

- resources are seconded to an entity in the host country but the entity in the home country continues to pay the salaries and other employment benefits of these resources;

- the entity in the home country pays the salaries of the resources and is reimbursed by the entity in the host country which is considered as an expense;
- the resources work under the supervision and control of the entity in the host country who generally does not have a mandate to terminate the employment services of the resource or change the terms of the employment contract;
- during the secondment period, the entity in the host country will bear the risk and is responsible for the resources' work from which it derives a benefit;
- the withholding tax that is due to the tax authorities in the host country on the salaries of the seconded resources may be paid by the entity in the host country and the 'net amount is remitted' to the entity in the home country; or
- the withholding tax that is due to the tax authorities in the host country on the salaries of the seconded resources 'is remitted' by the entity in the home country 'that receives the gross amount' from the entity in the host country.

For the purposes of this report, a subcontracting arrangement generally involves at least three parties contractually. To differentiate between the contracting parties, they are referred to as the following:

- the contractor based in the home or resident country also known as the prime entity;
- the entity that is given the contract to perform the services, based in another country other than the home country, is known as the sub-contractor or participating entity; and
- the client, who ultimately receives the services from the contractor.

3.3. Paragraph 1 and 2 of Article 15 in the *Model Tax Convention*

To understand the difference between the two types of arrangements, the commentary provided on Article 15 in the *Model Tax Convention* will be relied upon. Commentary in paragraph 8.14 of Article 15 of the *Model Tax Convention* provides various factors that are used to determine the economic employer (OECD, 2014:C(15)-16-17) of the resource. In terms of the commentary on paragraph 1 of Article 15 in the *Model Tax Convention*, income from employment is taxed in the jurisdiction 'where the employment is actually exercised' (OECD, 2014:C(15)-1) , (Taxand, (2012)). The commentary further states that:

> 'salaries, wages and other similar remuneration'

includes benefits that are received from employment exercised (OECD, 2014:C(15)-1).

Paragraph 2 of Article 15 in the *Model Tax Convention*, contains an exception to the rule indicated in paragraph 1 (OECD, 2014:C(15)-7) which stated that the country where employment is actually exercised will have taxing rights (Taxand, (2012)). According to paragraph 2, there are three requirements that must be met in order for the country of residence to have taxing rights and not the host country (Taxand, (2012)):

a) the resource may not spend more than 183 days

> 'in any twelve month period commencing or ending in the fiscal year concerned'

in the host country (OECD, 2014:C(15)-7);

b) 'the remuneration is paid by, or on behalf of,' an employer that is a resident of the home country (OECD, 2014:C(15)-10), and
c) the remuneration must not be borne by a permanent establishment the employer has in the country where the employment is exercised (OECD, 2014:C(15)-11).

The three requirements of paragraph 2 of Article 15, listed above, are now examined in greater detail. In determining the 183 days in any twelve month period, subparagraph 2 a) of Article 15 of the commentary in the *Model Tax Convention*, states that (OECD, 2014:C(15)-8-9):

- The method to be applied when calculating the 183 days should be the 'days of physical presence' method;
- The days included when applying the method are: a part of a day, the day of arrival, the day of departure and all days spent in the host country including Saturdays and Sundays, public holidays, holidays before, during and after the activity, short breaks, days of sickness and death or sickness in the family;
- Days spent in transit between two points outside the host country are excluded for the calculation; and
- Any entire day spent outside the host country, whether for holidays, business trips, or any other reason, are excluded from the calculation.

When determining the employer that pays the remuneration of the resource, subparagraph 2 b) of Article 15 of the commentary in the *Model Tax Convention*, states (OECD, 2014:C(15)-9-11):

- It is important to determine if there is a contract of service or a contract for services (OECD, 2014:C(15)-13) for this subparagraph; and

- It must be established whether the remuneration is paid by or on behalf of an employer that is not a resident in the country where the services are rendered, as this is used to allocate taxing rights to the correct tax authority.

Subparagraph 2 c) of Article 15 of the commentary in the *Model Tax Convention*, states that (OECD, 2014:C(15)-11):

- The purpose of the term 'borne by' is to ensure that remuneration may not be deducted by the permanent establishment based in the country where employment is exercised; and
- It is also important to determine if there is a contract of service or a contract for services (OECD, 2014:C(15)-13) for this subparagraph.

3.4 Contract of service and Contract for services

In terms of subparagraphs 2 b) and c) of Article 15, the commentary states that 'substance over form rules' have been developed in order to make a distinction between contracts that may be entered into (OECD, 2014:C(15)-13):

- Contract of service – services rendered by a resource to an entity considered to be rendered in an 'employment relationship'; and
- Contract for services – services considered to be rendered under a contract for the 'provision of services' between 'two separate' entities.

A contract must clearly indicate the type of arrangement that has been entered into (Ashley, (2013)). Generally, a secondment arrangement would be a 'contract of service' where there is an employment contract between the resources and their employer in the host country (Krishnamurthy, (2015)). There are instances where there is a contract of employment between the seconded resources and their formal employer based in the home country and a contract for the provision of services between the formal employer in the home country and the entity receiving the services which could be the client (Krishnamurthy, (2015)). A contract for services is more indicative of a contract that has been entered into between two entities (Krishnamurthy, (2015)).

3.5 Economic employer approach

The nature of services rendered by a resource is an important aspect as a resource provides services which is an 'integral part of the business activities carried on by his employer' (OECD, 2014:C(15)-16). An important element to consider is which entity bears the:

> 'responsibility or risk for the results produced by'

that resource especially when a resource renders services directly to an entity (OECD, 2014:C(15)-16). In determining the nature of services rendered by the resource, there are certain factors which need to be present in the business activities of his formal employer and the entity that receives the services which leads to understanding of who is the actual employer of the resource (Krishnamurthy, (2015)).

Even if a resource is legally employed by his formal employer, the host entity that receives the services or benefit can be interpreted to be the economic employer of the resource (Taxand, (2012)). There are important criteria in assuming the economic employer (Taxand, (2012)). According to the commentary provided in the *Model Tax Convention* on Article 15, the following factors may be relevant in determining whether the employment relationship is different to the formal contractual relationship (OECD, 2014:C(15)-16-17):

- 'who has the authority to instruct the individual regarding the manner in which the work has to be performed;
- who controls and has responsibility for the place at which the work is performed;
- the remuneration of the individual is directly charged by the formal employer to the enterprise to which the services are provided;
- who puts the tools and materials necessary for the work at the individual's disposal;
- who determines the number and qualifications of the individuals performing the work;
- who has the right to select the individual who will perform the work and to terminate the contractual arrangements entered into with that individual for that purpose;
- who has the right to impose disciplinary sanctions related to the work of that individual; and
- who determines the holidays and work schedule of that individual.'

In terms of the commentary on subparagraphs 2 a), b) and c) of Article 15 in the *Model Tax Convention* and the factors listed above; it is important to determine who is the employer in a contract but more specifically to differentiate between the formal employer and the 'economic employer' (Taxand, (2012)). The legal or formal employer of the resource will be based in the home country and may not be the same as the economic employer, who can be based in the host country (Taxand, (2012)).

The economic employer will thus be liable for tax in the host country as the exemption provided in paragraph 2 b) of Article 15 of the *Model Tax Convention* will not apply (Taxand, (2012)) as the remuneration is paid on behalf of an employer that is resident of the country where the services are rendered (Krishnamurthy, (2015)). The *Model Tax Convention* does not use the term 'economic employer' and as such does not provide a definition. Each country may have its own interpretation of this principle. (Taxand, (2012).)

Another aspect to consider is the 'financial arrangements' between the two entities. It is important to understand if the remuneration due to the resource is 'directly charged' by the formal employer to the entity that receives the services. (OECD, 2014: C(15)-17.) Therefore, if the entity in the home country charges the entity in the host country, this is more indicative of an employment relationship with the host country and so, the exemption provided in paragraph 2 b) of Article 15 cannot be applied as the remuneration is paid on behalf of an employer that is resident of the country where the services are rendered (OECD, 2014: C(15)-17).

Whether the fees charged for the remuneration and other employment benefits includes a 'profit element' or not is also of importance (OECD, 2014:C(15)-17). The profit element or mark-up is based on a percentage of the remuneration and other employment benefits which is used in determining if there is an employment relationship in place between the seconded resource and the entity in the host country (Krishnamurthy, (2015)), (OECD, 2014:C(15)-17). An arrangement would reflect a contract for services if the charge for the services 'bears no relationship to the remuneration' (OECD, 2014:C(15)-17) and is in terms of an arm's length transaction between the home entity and the host entity (Krishnamurthy, (2015)).

A suitable option would be that the seconded resource is transferred onto the payroll of the entity in the host country, which must be clearly stated in a contract (Krishnamurthy, (2015)).

The contract should be between the seconded resource and the entity in the host country for the secondment period and indicates the following (Krishnamurthy, (2015)):

- the resource is on the payroll of the host entity;
- the resource is under the control and supervision of the host entity;
- the resource can 'revert to the payroll' of the home entity after the secondment period, in which case it will be treated 'as a continuous service and not a break in service';
- the host entity will deduct any employees tax applicable in the host country and pay it to the tax authority; and
- as the secondment arrangement is with the entity in the host country, the resource will not be providing services on behalf of the entity in the home country.

Where a contract indicates that there is a contract for services this usually indicates that services will be provided between two separate entities (Krishnamurthy, (2015)). For the purposes of the report, the contract will be between two separate parties, the contractor and sub-contractor which are based in different countries. As a result, a contractor or sub-contractor may be required to render services over a prescribed period in a foreign jurisdiction. As indicated in subparagraph 2 a) of Article 15 in the *Model Tax Convention*, the resources should not exceed the 183 days threshold in a foreign jurisdiction and continued presence on projects must be monitored.

3.6. Conclusion

If the sending and receiving entities enter into a secondment agreement, where resources will render services in a foreign jurisdiction, it is important to establish who the economic employer of the resource is (Taxand, (2012)). There are certain factors that are generally present in determining the economic employer of that resource (Taxand, (2012)). If the receiving entity bears the risk and responsibility for the results produced by that resource and the resource is under the supervision and control of the receiving entity, then the receiving entity is considered to be the economic employer of that resource (Taxand, (2012)), (OECD, 2014:C(15)-16-17). If the contract is between the seconded resource and the receiving entity for the secondment period, a permanent establishment may not materialise for the entity in the home country through the presence of the resources through a secondment arrangement (Krishnamurthy, (2015)).

This may not hold true for a subcontracting arrangement, where the prime entity or participating entity may be required to render services in a foreign jurisdiction for a certain period of time. Subparagraph 2 a) of Article 15 of the applicable double tax agreement between the contracting entities indicates the maximum amount of time a resource can be present in the host country which could be for a period of 183 days or less. It is important to monitor the time spent by a resource in a country to determine which country has taxing rights on the salary of that resource.

The double tax agreements between the different jurisdictions where the prime and participating entities are based must be read to consider if there is a deeming permanent establishment provision in Article 5. A deemed permanent establishment is when the home entity creates a service permanent establishment in terms of Article 5 of the applicable double tax agreement by exceeding the days present in a country when performing services on a project in the host country (Ashley, (2013)). Further discussion on how a permanent establishment is created through a secondment arrangement and subcontracting arrangement is provided in chapter 4 with reference made to case law and specific double tax agreements.

CHAPTER 4: CREATING A SERVICE PERMANENT ESTABLISHMENT FROM OUTSOURCED SERVICES

4.1 Background

This chapter examines how a secondment arrangement and a subcontracting arrangement could both result in a permanent establishment for a non-resident entity in the host country. The definition of a permanent establishment in Article 5 in the *Model Tax Convention* is examined (OECD, 2014:C(5)-1). The deeming provision of a service permanent establishment in paragraph 42.23 of the commentary on Article 5 in the *Model Tax Convention* is also examined (OECD, 2014:C(5)-31-32).

Over the years there have been several court cases regarding a non-resident entity creating a permanent establishment in India. The two Indian cases which have been identified, *Centrica India Offshore (P.) Ltd. v. CIT* [2014] 364 ITR 336 and *DIT (IT) v. Morgan Stanley & Co.* [2007] 292 ITR 416 (SC) are discussed. The principles stated in these cases will be used as reference of how a service permanent establishment can be created for a non-resident entity from outsourcing services (Ashley, (2013)). It could be argued that multinational companies based in the United Kingdom (UK) and United States of America (USA) often outsource services to entities based in other jurisdictions. Both are developed countries and since the two Indian court cases involved entities based in the UK and the USA respectively, Article 5 of the double tax agreements between these countries and both South Africa, and India, will be discussed in this chapter.

4.2 Permanent establishment

Paragraph 1 of Article 5 in the *Model Tax Convention* defines a permanent establishment (OECD, 2014:C(5)-1):

> 'as a fixed place of business, through which the business of an enterprise is wholly or partly carried on.'

The definition of a permanent establishment is explained in the commentary on Article 5 of the *Model Tax Convention* which states that there are three conditions to the definition (OECD, 2014:C(5)-1-2):

- there must be a 'place of business' that exists such as premises;
- this place of business must be 'fixed' which has an indication that there is an establishment at a 'distinct place' which has a degree of permanency; and
- there is the 'carrying on of the business of the enterprise through this fixed place of business' which means that people or others are 'dependent' on the enterprise to conduct its business.

For the purpose of this report, certain commentary provided on the 'taxation of services' in terms of paragraph 42.11 to paragraph 42.47 of Article 5 of the *Model Tax Convention* is the focus of this chapter (OECD, 2014:C(5)-28-40). It is therefore necessary to examine the commentary relevant to a service permanent establishment. The commentary relating to other paragraphs of Article 5 will not be discussed as it falls out of the scope of this report.

4.3 Service permanent establishment

To explain what is meant by a service permanent establishment, commentary on Article 5 of the *Model Tax Convention* is examined. The *Model Tax Convention* commentary provides an example of the following optional provision that countries may include in their double tax agreements (OECD, 2014:C(5)-31-32):

> 'Notwithstanding the provisions of paragraphs 1, 2 and 3, where an enterprise of a Contracting State performs services in the other Contracting State:
>
> a) through an individual who is present in that other State for a period or periods exceeding in the aggregate 183 days in any twelve month period, and more than 50 per cent of the gross revenues attributable to active business activities of the enterprise during this period or periods are derived from the services performed in that other State through that individual, or
>
> b) for a period or periods exceeding in the aggregate 183 days in any twelve month period, and these services are performed for the same project or for connected projects through one or more individuals who are present and performing such services in that other State

> the activities carried on in that other State in performing these services shall be deemed to be carried on through a permanent establishment of the enterprise situated in that other State…'

It is important to note that this provision deems a permanent establishment to exist when there was none under the definition provided in paragraph 1 (OECD, 2014:C(5)-32). It does not seek to provide a different definition of a permanent establishment to that in paragraph 1 (OECD, 2014:C(5)-32). In addition, this deeming provision does not limit the scope of the definition in paragraph 1 (OECD, 2014:C(5)-32) as well as the lists of places of business constituting a permanent establishment mentioned under paragraph 2 of Article 5 (OECD, 2014:C(5)-9).

The *Model Tax Convention* commentary indicates that the services must be provided by an enterprise to a third party. The commentary further states that this optional provision:

> 'applies to services that are performed'

in a jurisdiction by a non-resident entity. The relevant services should be performed through resources that are present in that jurisdiction. It is not necessary for such services to be 'furnished to a resident' in that jurisdiction. (OECD, 2014:C(5)-34.)

There are two different sets of circumstances that are evident in the deeming provision which are examined further (OECD, 2014:C(5)-35):

- Subparagraph a) of this provision refers to the 'duration of the presence' of the resource through whom an entity 'derives most of its revenues' (OECD, 2014:C(5)-35). This is similar to subparagraph 2 a) of Article 15 in the *Model Tax Convention* (OECD, 2014:C(15)-7). Subparagraph 2 a) of Article 15 indicates a threshold for the amount of time a resource can be present in the host country. The manner of computing the days present in a country in terms of subparagraph 2 a) of Article 15 (OECD, 2014:C(15)-8-9) will also be applied to this subparagraph (OECD, 2014:C(5)-35); or
- Subparagraph b) of this provision refers to the 'duration of the activities' of the resource 'through whom the services are performed' (OECD, 2014:C(5)-35). 'Period or periods' refers to an entity and not the resources. It is also not relevant for the same resource or resources to be present over these periods to perform the services. In so far as an entity 'is performing its services' through a resource who 'is present' in the jurisdiction on any given day, that day will contribute to that 'period or periods.' (OECD, 2014:C(5)-37.) If an entire team is performing services for the entity on that day, that day will still

count as a ‘single day’ (OECD, 2014:C(5)-37). This subparagraph also states when the services performed by a resource or resources are in relation to a ‘particular project’ or for ‘connected projects.’ The interpretation of the phrase an entity:

> ‘performing these services for the same project’

is from the perspective of the entity ‘that provides the services.’ (OECD, 2014:C(5)-37.) An entity may provide services on two unrelated projects to one customer which should not be considered to be performed for the same or connected projects for the purposes of subparagraph b) of the deemed service permanent establishment provision (OECD, 2014:C(5)-37).

Services may be rendered by the resources in a foreign jurisdiction in aggregate for more than 183 days in any twelve month period on connected projects (OECD, 2014:C(5)-31-32). To understand what is meant by the term ‘connected projects’ commentary in the *Model Tax Convention* provides factors that are relevant (OECD, 2014:C(5)-37-38):

- whether the projects could be covered under a single master contract;
- if projects are covered under different contracts, are these contracts between the same person or related persons and whether there would be additional contracts after conclusion of the first contract;
- whether the nature of the work provided is the same under the different contracts; and
- whether the same resources are rendering the services mentioned in the different contracts.

Based on the definitions and criteria provided, it can be determined whether the home entity complies with the definition of a permanent establishment in terms of paragraph 1 of Article 5 (OECD, 2014:C(5)-1-2); or a service permanent establishment in terms of the optional provision (OECD, 2014:C(5)-31-32). These definitions found in Article 5 of the double tax agreements of South Africa and India will be examined later in this chapter. If the home entity has triggered a permanent establishment in the host country, only then can it be established if the business profits of the entity may be taxed by the tax authorities in the host country. Commentary on Article 7 of the *Model Tax Convention* provides such guidance. (OECD, 2014:C(7)-1.)

4.4 Business profits

Paragraph 1 of Article 7 of the *Model Tax Convention* states that:

> 'unless an enterprise of a Contracting State has a permanent establishment situated in the other State, the business profits of that enterprise may not be taxed by that other State.'

It is further stated that (OECD, 2014:C(7)-4):

> 'if such an enterprise carries on business in the other State through a permanent establishment situated therein, the profits that are attributable to the permanent establishment may be taxed by that other state.'

Therefore, if an entity in the home country provides its services to an entity in the host country, the income from the rendering of such services may be taxed in the host country if the former entity has a permanent establishment in terms of Article 5 (Pal, (2017)). In a secondment arrangement if the economic employer is based in the home country, the entity in the home country will have a permanent establishment in the host country (Ashley, (2013)). In a subcontracting arrangement, services may be rendered by a non-resident entity for more than the threshold in terms of the deemed provision in Article 5 of the double tax agreement and a service permanent establishment may arise (Ashley, (2013)). Article 5 does not allocate taxing rights merely when an entity in the home country carries on business through a permanent establishment in the host country (OECD, 2014:C(7)-1). It is necessary to determine 'what, if any, are the profits' that may be taxed by the tax authorities in the host country (OECD, 2014:C(7)-1).

In terms of Article 7 the following types of income are included:

> 'business income, service income, individuals' income from professional services and other activities of an independent character'

unless such income is addressed under a separate Article in the *Model Tax Convention* (Pal, (2017)). Paragraph 4 of Article 7:

> 'restricts the application of these rules by providing that Article 7 does not affect the application of other Articles'

in the *Model Tax Convention* that specifically cover other categories of profits or income (OECD, 2014:C(7)-4) 'that may also constitute business profits.'

4.5 Court cases

Over the years there have been several court cases relating to a non-resident entity creating a permanent establishment in India. The two Indian cases identified of which the principles are examined below are the *Centrica India Offshore (P.) Ltd. v. CIT* [2014] 364 ITR 336; and *DIT (IT) v. Morgan Stanley & Co.* [2007] 292 ITR 416 (SC).

4.5.1 *Centrica India Offshore (P.) Ltd. v. CIT* [2014] 364 ITR 336

Centrica India (Centrica) is a subsidiary of the parent entity incorporated in the United Kingdom (UK). The UK parent has two subsidiaries based in the UK and Canada which are referred to as the 'group entities.' Centrica does not form part of the group entities. Centrica was a newly established entity and it did not have an understanding of the practices of the group. (Ernst & Young, (2014).) Resources with the right level of 'knowledge and experience' were seconded from the group entities to Centrica under a secondment agreement to work with that entity in India (Ernst & Young, (2014)). The resources worked in India and reported to Centrica management. They were under the supervision and control of Centrica and were subjected to the same policies and procedures as the employees of the Indian entity. (Ernst & Young, (2014).) The salaries of the secondees were paid by the group entities and later recovered from Centrica (Ernst & Young, (2014)), (KPMG, (2014)). Centrica withheld taxes on the salaries for the services rendered in India (Ernst & Young, (2014)).

The Court found that the group entities were actually the 'real economic employer' of the secondees (KPMG, (2014)) and that the group entities rendered services in India through the secondees to Centrica (Ernst & Young, (2014)). The Court concluded that the group entities had a service permanent establishment in India (KPMG, (2014)) and that the payment made towards salaries would be taxed in India in the hands of group entities (Ernst & Young, (2014)). Since a service permanent establishment was created, the provisions of Article 7 were applicable and not Article 13, which deals with royalties and fees for technical services (KPMG, (2014)). The payment made by Centrica to the group entities on the reimbursement of the salary costs was taxed as business profits (KPMG, (2014)).

4.5.2 *DIT (IT) v. Morgan Stanley & Co*. [2007] 292 ITR 416 (SC)

Morgan Stanley & Co. (MS & Co) is a multinational entity that is incorporated in the United States of America (US), hereafter referred to as the US entity. The US entity provides and outsources many support functions to other entities (Tanikella & Ajinkya, 2007:2), (KPMG, (2014)). One such entity to which support services were outsourced was an Indian entity, Morgan Stanley Advantage Services Private Limited (MSAS) (Tanikella & Ajinkya, 2007:2). The US entity entered into a service agreement with MSAS to provide support services. These support services included functions such as information technology support; account reconciliation and research support. (Tanikella & Ajinkya, 2007:3.)

The US entity sent resources to India to 'undertake stewardship activities' to ensure 'quality control standards' were maintained (Tanikella & Ajinkya, 2007:3), (KPMG, (2014)). Resources from the US entity were also seconded to MSAS to render services (Tanikella & Ajinkya, 2007:3). These resources were under the supervision and control of MSAS and were managed by its board of directors (KPMG, (2014)). The salaries of the seconded resources were paid by the US entity after deducting withholding tax on the salaries in terms of s 192 of the Income-tax Act, 1961. The US entity was then reimbursed by MSAS for the salaries paid (KPMG, (2014).)

The Income Tax Appellate Tribunal in India determined that the seconded resources were the 'real employees' of the US entity who rendered services in India 'on behalf of' the US entity (Ernst & Young, (2015)). As a result of the services rendered, the Supreme Court also concluded that the resources created a service permanent establishment for the US entity as the resources had exceeded the threshold of 90 days in India in terms of the double tax agreement between India and the US (Ernst & Young, (2015)), (Tanikella & Ajinkya, 2007:3). The US entity remained in control of the resources' 'terms and employment' and as a result the resources did not become employees of MSAS. Furthermore, the resources remained on the payroll of the US entity (Tanikella & Ajinkya, 2007:4).The services rendered by the seconded resources were not for the US entity but rather 'for and to' MSAS (Tanikella & Ajinkya, 2007:4). Since the US entity was the real employer of the resources, a service permanent establishment was created in terms of Article 5(2)(l) of the India-US double tax agreement (Tanikella & Ajinkya, 2007:4).

The Supreme Court found that as MSAS would perform 'back-office operations,' Article 5(1) of the India-US double tax agreement was not applicable (Tanikella & Ajinkya, 2007:3, 4). Back-office operations rendered by MSAS cannot be seen as the business of the US entity as it constitutes services which are preparatory or auxiliary in nature (Tanikella & Ajinkya, 2007:4). Such services even if performed at a fixed place of business will not constitute a permanent establishment for the US entity (Tanikella & Ajinkya, 2007:3, 4). Also, the resources involved in the stewardship activities were not seen to create a service permanent establishment for the US entity in India, as this activity is part of a 'worldwide operation' to maintain 'quality control and confidentiality' for the US entity. The resources under this agreement were sent to 'protect the interest of MS & Co'. Therefore, the US entity could be rendering services to the Indian entity. (Tanikella & Ajinkya, 2007:4.) The Supreme Court in India stated that the US entity (Tanikella & Ajinkya, 2007:4):

> 'is merely protecting its own interests in the competitive world by ensuring the quality and confidentiality of MSAS services.'

4.6 Double tax agreements

The two court cases mentioned above resulted in entities based in the UK and USA creating a service permanent establishment in India. Article 5(1) and the service permanent establishment article in the double tax agreements of South Africa and India with the UK/USA respectively, will be examined. The definition of a permanent establishment in terms of Article 5(1) of the South Africa and UK/USA double tax agreements and the India and UK/USA double tax agreements is as follows:

> 'For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.'

The definition of a permanent establishment in Article 5(1) of the relevant double tax agreements are the same. The service permanent establishment provision in Article 5 of the double tax agreements of South Africa and India with the UK/USA respectively have been tabulated to note the significant difference in the duration of time that could be spent in the country. Refer to Annexure A which contains the extracts of the service permanent establishment provision in Article 5 of the respective double tax agreements.

Countries	*South Africa*	*India*
UK	183 days (Article 5(3)(b))	90 days (Article 5(2)(k)(*i*))
USA	183 days (Article 5(2)(k))	90 days (Article 5(2)(l)(*i*))

The length of time that a resource spends providing services in the host country can create a permanent establishment for the entity in the home country (Ashley, (2013)). Most countries double tax agreements provide for a period of 90 days to 180 days (Ashley, (2013)). India provides for a period of 90 days in the double tax agreements with the UK and USA. South Africa provides for a period of 183 days in the double tax agreements with the UK and USA. Especially since a non-resident entity may be required to render services in South Africa or India, the effect in having a low threshold means that a service permanent establishment can be created more quickly in India (Morrison, Reilly & West, (2009)) than in South Africa.

As noted in the case *DIT (IT) v. Morgan Stanley & Co. [2007] 292 ITR 416 (SC)*, the resources' presence in India exceeded the threshold, and so a permanent establishment was created for the home entity in India (Ernst & Young, (2015)), (Tanikella & Ajinkya, 2007:3). In India, a service permanent establishment is when resources provide services for a period that exceeds the threshold (Morrison, Reilly & West, (2009)).

In *Centrica India Offshore (P.) Ltd. v. CIT* [2014] 364 ITR 336, since the seconded resources were continued to be paid by the entity in the home country, this created a permanent establishment for the entity of the home country in the host country (Ashley, (2013)). If the seconded resources were transferred onto the payroll of the entity in the host country and a separate contract was entered into between the resource and that entity (Ashley, (2013)), a permanent establishment could have been avoided for the entity in the home country through the presence of the resources through a secondment arrangement (Krishnamurthy, (2015)). The entity in the home country can be used as a 'payroll agent' for the entity in the host country (Ashley, (2013)). As an agent, the entity can charge the costs back to the entity in the host country, but 'exclude it from the general management fee' (Ashley, (2013)).

4.7 Conclusion

As outsourcing arrangements become more prevalent with global companies it is important to determine whose business is actually being conducted in the foreign jurisdiction (Tanikella & Ajinkya, 2007:5). Having a fixed place of business is not adequate as it is important to establish 'whose business is being carried out through such a fixed place' (Tanikella & Ajinkya, 2007:5) to determine if a permanent establishment has been created. Factors such as the economic employer principle and the time spent in a country must be considered (Tanikella & Ajinkya, 2007:5) in determining whether a permanent establishment has been created. The following chapter will discuss the South African tax provisions that apply in an outsourcing arrangement.

CHAPTER 5: SOUTH AFRICAN DIRECT INCOME TAX PROVISIONS THAT APPLY TO OUTSOURCING ARRANGEMENTS

5.1 Background

This chapter provides an analysis of certain provisions from the Act applicable to corporates and individuals. The provisions applicable to an entity that has a permanent establishment in South Africa are also discussed in this chapter. Also, provisions applicable to a resident and non-resident individual due to working in South Africa are discussed in this chapter. The definition of a resident company and individual has already been discussed in chapter 2.2.1 and 2.2.2 respectively of this report. The following definitions in terms of s 1 of the Act are examined: company, gross income, permanent establishment, taxable income and year of assessment.

Section 5(1) and s 5(2) of the Act provide for the levy of tax and the tax rates, which will be examined in this chapter. Section 6(2) (*a*), (*b*) and (*c*) of the Act provide the various tax rebates applicable to a natural person, which are analysed. South African legislation provides for tax thresholds defined under paragraph 1 of the Fourth Schedule of the Act. These will be examined. This chapter analyses the applicable tax rates, tax rebates and tax thresholds for the 2017 year of assessment (SARS, (2017a)), (SARS, (2017c)).

5.2 Definitions and other tax provisions

The definition of a '**company**' in terms of s 1 of the Act includes the following:

- any association, corporation or company incorporated or deemed to be incorporated by or under any law in force in the Republic; or
- any association, corporation or company incorporated under the law of any country other than the Republic.

As a result of this definition, an entity incorporated in or outside South Africa is considered a company for South African income tax purposes. This is relevant in determining who is liable for tax. A company incorporated outside South Africa can still be regarded as a non-resident

but will be subjected to tax if it receives income sourced in South Africa in terms of the gross income definition (SARS, 2016:28).

In order to determine what income a resident and non-resident will be taxable on, the definition of gross income will be examined. The definition of '**gross income**' in terms of s 1 of the Act states that in relation to any year or period of assessment: gross income means…

- in the case of any resident;
    - the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or
- in the case of any person other than a resident;
    - the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within the Republic,

excluding receipts or accruals of a capital nature.

Income of a capital nature is included in determining taxable income but not gross income (SARS, 2016:8). Receipts or accruals that are capital in nature are dealt with in terms of provisions in the Eighth Schedule of the Act. These provisions will determine whether there is a taxable capital gain or assessed capital loss. Section 26A of the Act, states that a taxable capital gain must be included in taxable income in a year of assessment. (SARS, 2016:53.)

With effect from 1 January 2001, South Africa changed from the source-based system of taxation to a residence basis of taxation. Years of assessment commencing on or after that date were affected. (SARS, 2012:9.) This was in respect of all income, subject to certain exemptions (SARS, 2012:9). As of 2001, residents are now taxed in South Africa on their worldwide taxable income (SARS, 2012:9). If a resident entity conducted any business activity outside of South Africa, it is subject to tax as a resident is taxed on worldwide taxable income (SARS, 2016:5, 28). Income will be taxed in South Africa as well as the country where the business is conducted (SARS, 2016:28). All non-residents are still taxed in South Africa on their income from a source within or deemed to be within South Africa (SARS, 2012:9).

Since the report discusses how a permanent establishment is created and how it is taxed, it is necessary to define the term. The definition of a '**permanent establishment**' in terms of s 1 of the Act means:

> ‘a permanent establishment as defined from time to time in Article 5 of the Model Tax Convention on Income and on Capital of the Organisation for Economic Co-operation and Development.’

This definition makes reference to the term defined in Article 5 of the *Model Tax Convention*. When referring to the definition of a permanent establishment in the Act, the definition provided in the *Model Tax Convention* must be referred to. The definition of a permanent establishment as stated in Article 5 has been examined in chapter 4.2 of this report. For South African income tax purposes, a non-resident company that operates through a branch or has a permanent establishment in South Africa is subject to tax on all income that is sourced in South Africa (SARS, (2017b)) unless relief may be granted in terms of a double tax agreement between South Africa and the foreign country (SARS, 2016:28).

The purposes of determining the basis on which income for a resident and non-resident will be taxed, are to ultimately calculate the taxable income of the person and rate at which that person is taxed in a year of assessment. The definitions of taxable income and year of assessment will now be examined. The definition of ‘**taxable income**’ in terms of s 1 of the Act means the aggregate of:

- the amount remaining after deducting from the income of any person all the amounts allowed under Part I of Chapter II to be deducted from or set off against such income; and
- all amounts to be included or deemed to be included in the taxable income of any person in terms of this Act.

The basic steps in calculating taxable income are as follows (SARS, 2016:8), (SARS, 2012:44):

- gross income that is received by or accrued to a company or individual;
- less exempt income;
- to determine income, thereafter
- add specific inclusions;
- less deductions and allowances;

- add any taxable capital gain;
- to arrive at taxable income.

Finally in terms of the gross income definition, income must be determined in relation to a year or period of assessment for a person. The definition of '**year of assessment**' in terms of s 1 of the Act means:

> 'any year or other period in respect of which any tax or duty leviable under this Act is chargeable, and any reference in this Act to any year of assessment ending the last or the twenty-eighth or the twenty-ninth day of February shall, unless the context otherwise indicates, in the case of a company or a portfolio of a collective investment scheme in securities be construed as a reference to any financial year of that company or portfolio ending during the calendar year in question.'

From this definition, the year of assessment for a natural person covers a twelve month period, commencing on 1 March of a specific year and ending on the last day of February of the following year (SARS, 2016:5). In the case of a company, the year of assessment also covers a twelve month period, where the 'year of assessment ends on a date that coincides' with the company's financial year-end (SARS, 2016:6). The year of assessment for a natural person and company are also detailed in s 5 (1) of the Act and s 5(2) governs the rate of tax on taxable income.

Section 5(1) and s 5(2) of the Act, state the '**Levy of normal tax and rates**' which reads as follows:

> (1) 'Subject to the provisions of the Fourth Schedule there shall be paid annually for the benefit of the National Revenue Fund, an income tax (in this Act referred to as the normal tax) in respect of the taxable income received by or accrued to or in favour of— …
>
> (*c*) any person (other than a company) during the year of assessment ending during the period of 12 months ending the last day of February each year; and
>
> (*d*) any company during every financial year of such company.

(2) (*a*) The Minister may announce in the national annual budget contemplated in section 27 (1) of the Public Finance Management Act 1999, that, with effect from a date or dates mentioned in that announcement, the rates of tax chargeable in respect of taxable income will be altered to the extent mentioned in the announcement.

(*b*) If the Minister makes an announcement of an alteration contemplated in paragraph (*a*), that alteration comes into effect on the date or dates determined by the Minister in that announcement and continues to apply for a period of 12 months from that date subject to Parliament passing legislation giving effect to that announcement within that period of 12 months.'

In terms of s 5(1)(*c*) and s 5(1)(*d*) of the Act, normal tax will be paid to the National Revenue Fund in respect of taxable income that is received by or accrued to a natural person or company in their respective year of assessment. In terms of s 5(2)(*a*) and s 5(2)(*b*) of the Act, the Minister of Finance makes known in the national budget speech the rates of tax applicable for that year of assessment that are charged in respect of taxable income. In terms of s 5(2)(*a*) and s 5(2)(*b*) the effective dates of the tax rates are also announced in the speech. Once these rates are updated they are published on the SARS website (SARS, (2017a)), (SARS, (2017c)).

5.3 Tax rates

Once the taxable income for a company over a 12-month period has been calculated, the normal tax payable will be calculated by applying the company tax rate to the taxable income (SARS, 2016:8). Corporates incorporated in or outside South Africa are taxed at a flat rate of 28% on taxable income (SARS, (2017b)), (SARS, (2017c)). There are other types of companies such as small business corporations that are taxed at different rates (SARS, (2017c)).

Once the taxable income for a natural person has been calculated, the normal tax payable will be calculated by applying the relevant rate of tax to the taxable income (SARS, 2016:8). This is according to the following tax table for the 2017 year of assessment, 1 March 2016 - 28 February 2017 (SARS, (2017a)):

Taxable income	*Rates of tax*
0 – R188 000	18% of taxable income
R188 001 – R293 600	R33 840 + 26% of taxable income above R188 000
R293 601 – R406 400	R61 269 + 31% of taxable income above R2913 600
R406 401 – R550 100	R96 264 + 36% of taxable income above R406 400
R550 101 – R701 300	R147 996 + 39% of taxable income above R550 100
R701 301 and above	R206 964 + 41% of taxable income above R701 300

5.4 Tax rebates

South African income tax legislation provides for tax rebates which are applicable to a natural person. The relevant tax rebate will be deducted from the normal tax payable to determine the final tax liability (SARS, 2016:8). Section 6(2) of the Act provides for '**normal tax rebates**':

> (*a*) 'a primary rebate, an amount of R13 500;
>
> (*b*) a secondary rebate, if the taxpayer was or, had he or she lived, would have been 65 years of age or older on the last day of the year of assessment, an amount of R7 407; and
>
> (*c*) a tertiary rebate if the taxpayer was or, had he or she lived, would have been 75 years of age or older on the last day of the year of assessment, an amount of R2 466.'

If a natural person is 65 years or older, that person will qualify for a primary and secondary rebate. If a natural person is 75 years or older, that person will qualify for a primary, secondary and tertiary rebate. (SARS, 2016:65.)

5.5 Tax threshold

In terms of paragraph 1 of the Fourth Schedule of the Act, '**tax threshold**' is defined as:

> 'in relation to a natural person means the maximum amount of taxable income of that person in respect of a year of assessment which would result in no tax payable when the rates of tax contemplated in section 5 of this Act and the rebates contemplated in section 6 of this Act for that year of assessment are applied to the taxable income of that person.'

Once taxable income for a natural person exceeds the tax threshold, that natural person will be liable to submit a tax return in that relevant year of assessment (SARS, 2016:12). The threshold changes yearly and differs depending on the age of the natural person (SARS, 2016:12). For the 2017 year of assessment, the various tax thresholds applicable to a natural person are as follows (SARS, (2017a)):

Natural person	***Threshold amount***
Below the age of 65 years	R75 000
65 years or older but less than 75 years	R116 150
75 years or older	R129 850

5.6 Conclusion

In this chapter certain South African income tax provisions were defined and examined. A resident's worldwide taxable income is subject to tax and a non-resident's taxable income from a South African source will be subject to tax (SARS, 2016:5). The rates for a company and natural person were identified for the 2017 year of assessment. A corporate will be taxed at a flat rate of 28% (SARS, (2017c)) and natural persons (SARS, (2017a)) are taxed according to a sliding scale of income. Natural persons are allowed tax rebates in terms of s 6(2) (*a*), (*b*) and (*c*) which are applied according to a person's age. The following chapter will focus on the income tax provisions in India.

CHAPTER 6: INDIAN DIRECT INCOME TAX PROVISIONS THAT APPLY TO OUTSOURCING ARRANGEMENTS

6.1 Background

This chapter provides an analysis of certain provisions in terms of the Income-tax Act, 1961 applicable to corporates and individuals. The provisions that are applicable to an entity that has a permanent establishment in India are discussed in this chapter. Also, provisions applicable to a resident and non-resident individual working in India are discussed in this chapter. The definition of a resident company and individual has already been discussed in chapter 2.3.1 and 2.3.2 respectively of this report. The following definitions in terms of s 2 of the Income-tax Act, 1961, are examined: an assessment year, company, person and total income. The definition of previous year is analysed which is found in s 3.

The basis to charge tax at a tax rate, as provided in s 4, is examined. The 'scope of total income' for a resident and non-resident, found in s 5(1) and s 5(2) respectively, are also examined. The Income-tax Act, 1961 defines a permanent establishment for transfer pricing purposes only. In India, the concept of a business connection exists which has a wider meaning. (Nishith Desai Associates, 2003:18.) The concept of a business connection which will be examined is found in s 9(1)(*i*). The tax rebate which will also be examined is found in s 87A. This chapter also addresses the applicable tax rates and tax thresholds for the 2017 assessment year (Income Tax Department, (2017a)).

6.2 Definitions and other tax provisions

In order to determine the income that a person in India will be taxed on as well as the tax rate that person will subjected to, it is necessary to define a person for income tax purposes in India. Section 2(31) of the Income-tax Act, 1961, provides the definition of a '**person**' which for the purpose of this report includes:

- an individual, and
- a company.

The definition of a company is examined. In terms of s 2(17) of the Income-tax Act, 1961, a '**company**' is defined as follows:

- 'any Indian company, or
- any body corporate incorporated by or under the laws of a country outside India, or
- any institution, association or body which is or was assessable or was assessed as a company for any assessment year under the Indian Income-tax Act, 1922, or
- any institution, association or body, whether incorporated or not and whether Indian or non-Indian, which is declared by general or special order of the Board to be a company…'

To understand the definition of a company in India, other specific definitions must be referred to which are found under the various subsections of s 2 of the Income-tax Act, 1961. Definitions which are relevant for the purpose of this report are the following: Indian company, foreign company and domestic company. Also, since foreign and domestic companies are taxed at different rates, it is necessary to define both types of companies (Income Tax Department, (2017a)).

Section 2(26) of the Income-tax Act, 1961 defines an '**Indian company**' as a company that is formed and registered under the Companies Act, 1956, and includes:

- a company formed and registered under any law relating to companies formerly in force in any part of India...:
  - a corporation established by or under a Central, State or Provincial Act;
  - any institution, association or body which is declared by the Board to be a company under the definition of a company found under s 2(17)…

Provided that the registered or, as the case may be, principal office of the company, corporation, institution, association or body in all cases is in India.

From this definition it can be deduced that a company formed under the laws in any part of India is considered an Indian company if the principal office is in India. If a company is not

registered in India, then that company is a foreign company, of which the definition is provided below.

In the case where a company is formed 'under laws of a country outside India' in terms of s 2(17)(*ii*) of the Income-tax Act, 1961, such a company is considered to be a '**foreign company**'. In terms of s 2(23A) of the Income-tax Act, 1961 a foreign company means:

> 'a company which is not a domestic company.'

Lastly, the term '**domestic company**' will be examined. This term is defined under s 2(22A) of the Income-tax Act, 1961 and means:

> 'an Indian company, or any other company which, in respect of its income liable to tax under the Income-tax Act, 1961…'

From these definitions it can be established that an Indian company is considered a domestic company but not all domestic companies are considered to be Indian companies as stated in s 2(22A) of the Income-tax Act, 1961. A foreign company is a company which is not a domestic company in terms of s 2(22A) of the Income-tax Act, 1961 and such a company will be registered outside of India or has its principal office outside of India in terms of the proviso of s 2(26) of the Income-tax Act, 1961.

A person and company will be taxed at a particular rate on income that is applicable in an assessment year (Income Tax Department, (2017a)) and the year that income is earned is known as the previous year (KPMG, (2016)). The definitions of assessment year and previous year are now examined. Section 2(9) of the Income-tax Act, 1961, provides the definition of '**assessment year**' as follows:

> 'the period of twelve months commencing on the 1st day of April every year.'

In terms of this definition there is no differentiation between a company and individual. Both have the same assessment year of twelve months commencing on 1 April and ending on 31 March of the following year. Income that is earned during a year will be taxed in that year

(KPMG, (2016)). This definition must be read together with the definition of 'previous year' found in s 3 of the Income-tax Act, 1961.

The defintion of '**previous year**' which is found under s 3 of the Income-tax Act, 1961 means:

> 'the financial year immediately preceding the assessment year.'

The assessment year, as discussed commences on 1 April and ends on 31 March of the following year. The year that income is earned is known as the financial year or previous year. Therefore, the assessment year comprising of a twelve month period, follows the previous year. (KPMG, (2016).)

The '**basis of charge of income tax**' in respect of total income of a person for an assessment year is stated in s 4 of the Income-tax Act, 1961 which reads as follows:

> (1) 'Where any Central Act enacts that income-tax shall be charged for any assessment year at any rate or rates, income-tax at that rate or those rates shall be charged for that year in accordance with, and subject to the provisions (including provisions for the levy of additional income-tax) of, this Act in respect of the total income of the previous year of every person:
>
> Provided that where by virtue of any provision of this Act income-tax is to be charged in respect of the income of a period other than the previous year, income-tax shall be charged accordingly.
>
> (2) In respect of income chargeable under sub-section (1), income-tax shall be deducted at the source or paid in advance, where it is so deductible or payable under any provision of this Act.'

In terms of s 4(1) and s 4(2), income tax shall be charged at a tax rate for any assessment year in respect of the total income of the previous year of every person, which for the purposes of this report are on an individual and a company. In terms of s 4 the right to charge a tax on total income has been established. Total income earned during period 1/4/2016 to 31/3/2017 is earned in the previous year 2016-2017 which will be assessed in the assessment year 2017-2018 (KPMG, (2016)).

Before determining the rate of tax to be levied on total income, total income and the 'scope of total income' must be defined and examined. Section 2(45) of the Income-tax Act, 1961, provides the definition of '**total income**' which means:

> 'the total amount of income referred to in section 5, computed in the manner laid down in this Act.'

The '**scope of total income**' which is found under s 5(1) and s 5(2) of the Income-tax Act, 1961 for a resident and non-resident respectively, reads as follows:

Total income of a Resident - s 5(1) of the Income-tax Act, 1961**:**

> 'The total income of any previous year of a person who is a resident includes all income from whatever source derived which:
>
> - is received or is deemed to be received in India in such year by or on behalf of such person; or
> - accrues or arises or is deemed to accrue or arise to him in India during such year; or
> - accrues or arises to him outside India during such year:
>
> Provided that, in the case of a person not ordinarily resident in India within the meaning of sub-section (6) of section 6, the income which accrues or arises to him outside India shall not be so included unless it is derived from a business controlled in or a profession set up in India.'

In the case of a person that is not ordinarily resident in India in terms of s 6(6) of the Income-tax Act, 1961, income that accrues or arises to such a person outside India will not be included in total income, unless the income is derived from a business controlled in India or from a profession set up in India in terms of the proviso of s 5(1) of the Income-tax Act, 1961.

Total income of a Non-resident - s 5(2) of the Income-tax Act, 1961**:**

> 'The total income of any previous year of a person who is a non-resident includes all income from whatever source derived which:

- is received or is deemed to be received in India in such year by or on behalf of such person; or
- accrues or arises or is deemed to accrue or arise to him in India during such year.'

In determining total income for a person, income from various sources or rather 'heads of income' must be accounted (Income Tax Department, (n.d.-b)). For a company or individual, the heads of income include the following (Income Tax Department, (n.d.-b)), (Taxmann, (n.d.)):

- Income from salaries;
- Income or loss from house property;
- Profit and gain from business and profession;
- Income from capital gains; and
- Income from other sources.

Each head of income allows for eligible deductions, allowance and reliefs (Income Tax Department, (n.d.-b)). The income from the above heads of income are totaled and then subject to further deductions to arrive at taxable income (Income Tax Department, (n.d.-b)), (Taxmann, (n.d.)). The respective tax rates will be applied to taxable income for a company and individual (Taxmann, (n.d.)). These are discussed in 6.3 of this chapter.

A resident and ordinarily resident individual will be taxed on worldwide income. A non-resident individual is taxed on income that is received or is deemed to be received or accrues or arises or is deemed to accrue or arise in India. A resident but not ordinarily resident individual is taxed like a non-resident individual and is also taxed on income that accrues or arises outside India that is derived from a business controlled in India or from a profession set up in India. (PwC, (2017b).)

Due to the various residency statuses that are applicable to an individual, as identified in chapter 2.3.2, and the various sources of income identified in s 5(1) and s 5(2), the table below taken from the *Advance Learning On Basic Concepts & Residential Status* provides a comprehensive

approach to determining how such income is taxed according to the residency statuses in India (Income Tax Department, (n.d.-a)):

- Resident and Ordinarily Resident in India (ROR);
- Resident but Not Ordinarily Resident in India (RNOR);
- Non-Resident in India (NR).

Source of income	***Residency status***		
	ROR	*RNOR*	*NR*
Income accrued in India	✓	✓	✓
Income deemed to be accrued in India	✓	✓	✓
Income received in India	✓	✓	✓
Income deemed to be received in India	✓	✓	✓
Income other than above, but from a business controlled from India	✓	✓	×
Income other than above (income which has no relation with India)	✓	×	×

Since the report examines how a permanent establishment is created in India, the source of income rules applicable to a permanent establishment or alternatively, a business connection in India is examined. A 'business connection is the Indian equivalent of permanent establishment' (Nishith Desai Associates, 2003:18). In Indian domestic legislation the definition of a permanent establishment is found under s 92F(*iiia*) of the Income-tax Act, 1961

which is only relevant for transfer pricing provisions (Nishith Desai Associates, 2003:18). Transfer pricing will not be discussed as it is not part of the scope of this report.

The concept of a business connection has a wide meaning (Nishith Desai Associates, 2003:18). The term business connection is not defined in the Income-tax Act, 1961 but rather an explanation is provided in s 9(1)(*i*) (Nishith Desai Associates, 2003:20). The Bombay High Court stated that since the term business connection has (Nishith Desai Associates, 2003:20):

> 'no precise definition, the solution of the question must depend upon the particular facts of each case.'

Section 9(1)(*i*) of the Income-tax Act, 1961 states that the following income shall be deemed to accrue or arise in India:

> 'all income accruing or arising, whether directly or indirectly, through or from any business connection in India…'

The Bombay High Court stated that in order for a business connection to exist there should be (Nishith Desai Associates, 2003:20):

> 'a business in India, a connection between non-resident person or company and that business and that the non-resident person or company has earned an income through such connection.'

In a judgment of the Andhra Pradesh High Court, the following principles were laid for a business connection to exist (Nishith Desai Associates, 2003:22):

- Continuity of activity or connection between the non-resident entity and the Indian entity;
- Real and intimate connection between the activity carried on by the non-resident entity outside India with the activity carried out in India;
- Attribution of income of the business carried out in India;
- Common control between non-resident entity and the Indian entity; and
- Includes a professional connection.

Even though the concept of a business connection may be regarded as the Indian version of a permanent establishment in a double tax agreement, the meaning of the former is broader (Mehta, (2014)). The definition of a permanent establishment as defined specifically in a double tax agreement and is confined to cover what is stated in the definition (Govind, 2001:190). The concept of a business connection applies in the following circumstances (Govind, 2001:190), (Mehta, (2014)):

- areas not specifically covered by the definition of a permanent establishment in double tax agreements; and
- the taxation of income from a transaction between entities where there is no double tax agreement between the two countries.

If inconsistencies exist between a double tax agreement and a provision in the Income-tax Act, 1961, the provisions in the double tax agreement will prevail (Govind, 2001:193). The requirements set out in chapter 4.2 and 4.3 of this report are still relevant in determining if a permanent establishment exists in terms a double tax agreement as this is necessary for the taxation of business profits (Govind, 2001:192). The requirement for an entity to have a business connection in India is not dependent on the requirements of a permanent establishment in terms of a double tax agreement (Mehta, (2014)). The requirements for a business connection (Nishith Desai Associates, 2003:22) must be considered as well as the facts of each case (Nishith Desai Associates, 2003:20) in determining if a business connection exists.

The concept of a business connection does not require that a fixed place of business should exist for a business connection to exist. This is a requirement for a permanent establishment in terms of Article 5(1) in the *Model Tax Convention* (Mehta, (2014).) The existence of a business connection does not depend on a time threshold such as that indicated in the service permanent establishment provision in terms of a double tax agreement between India and the other country (Mehta, (2014)). If the five principles mentioned above exist, the non-resident entity could have a business connection in India. If a non-resident entity does not have income accruing or arising, whether directly or indirectly, through or from any business connection in India then the non-resident entity's business income would not be taxable in India, regardless of the implication in a double tax agreement. (Mehta, (2014).) In the event, a non-resident entity does

earn income through or from a business connection in India such income will be taxed in India (Nishith Desai Associates, 2003:20). The inter-relationship between a business connection and a permanent establishment in terms of Indian tax legislation is complex and is treated on a case by case basis. This will not be explored further as it is outside the scope of the report.

6.3 Tax rates

Once taxable income for a company has been determined in the assessment year, the company will be liable for tax at a particular rate. Tax rates for companies differ between a domestic company and a foreign company. Both are however, taxed at a flat rate on taxable income. (Income Tax Department, (2017a).) A company will also be liable for surcharges when total taxable income exceeds a threshold (PwC, (2017a)). The moment a foreign company has a permanent establishment in India (KPMG, 2015:1) in terms of a double tax agreement or a business connection in India (Nishith Desai Associates, 2003:20), it will be taxed according to the foreign company rate.

Company	***Rate of tax***
Domestic company	30%
Foreign company	40%

In India, resident individuals are taxed according to different tax tables depending on the age of the individual. For a non-resident individual, however, there is no differentiation made according to the person's age (Income Tax Department, (2017a).) Individuals are taxed in terms of the following categories (Income Tax Department, (2017a)):

- Resident individual below the age of 60 years (born on or after 01/04/1957);
- Resident individual of the age of 60 years or above at any time during the year but below the age of 80 years (born during 01/04/1937 to 31/03/1957);
- Resident individual of the age of 80 years or above at any time during the year (born before 01/04/1937); and

- Non-resident individual irrespective of the age.

For the purpose of this report, a non-resident individual refers to an individual who may be seconded or be required to work outside his/her home country. The tax table for a non-resident individual is the same as a resident individual below the age of 60 years (Income Tax Department, (2017a)), (KPMG, (2016)). The tax table for this category is provided below for the assessment year 2017-2018, which is the financial year 2016-2017, also known as previous year (Income Tax Department, (2017a)).

The table below has the normal tax rates applicable to a resident individual below the age of 60 years - born on or after 01/04/1957 and a non-resident individual (Income Tax Department, (2017a)), (KPMG, (2016)):

Taxable income brackets in Rs.	***Income tax rates in Rs.***
0 – 250,000	0%
250,001 – 500,000	10% of the excess over 250,000
500,001 – 1,000,000	25,000 + 20% of the excess over 500,000
Above 1,000,001	125,000+ 30% of the excess over 1,000,000

6.4 Tax rebates

In terms of s 87A, tax rebates are only applicable to resident individuals in India (Income Tax Department, (2017a)). The rebate is applicable on the:

> 'lower of the entire income tax and Rs. 5,000'

where the annual total income does not exceed Rs. 500,000 (PwC, (2017b)). Once the tax has been determined according to the tax table for individuals, the rebate will be deducted to arrive at total tax payable (Income Tax Department, (2017a)).

6.5 Tax thresholds

A person will be liable for tax in India when taxable income exceeds the applicable tax threshold depending on the relevant age category (KPMG, (2016)), (Income Tax Department, (2017a)):

Individual	***Threshold amount in Rs.***
Resident individual below the age of 60 years	250,000
Resident individual of the age of 60 years or above at any time during the year but below the age of 80 years	300,000
Resident individual of the age of 80 years or above at any time during the year	500,000
Non-resident individual	250,000

6.6 Conclusion

From the analysis of the definition of total income in s 5, a resident company's worldwide income is subject to tax and a non-resident's income that is received in India, or that accrues or arises, or is deemed to accrue or arise, in India will be subject to tax (PwC, (2017a)). A resident and ordinarily resident individual is taxed on worldwide income and a non-resident individual is taxed on income that is received or is deemed to be received or accrues or arises or is deemed to accrue or arise in India (PwC, (2017b)).

The rates for a company and individual were identified for the 2017-2018 assessment year. A domestic company will be taxed at 30% and a foreign company at 40% (Income Tax Department, (2017a).) Individuals are taxed according to a sliding scale of income (Income Tax Department, (2017a)). Only resident individuals are allowed tax rebates (Income Tax Department, (2017a)).

As examined in 6.2 of this chapter, a business connection is not dependent on the same requirements as a permanent establishment or a service permanent establishment in terms of Article 5 of a double tax agreement between India and the other country (Mehta, (2014)). If a non-resident entity does not have income accruing or arising, whether directly or indirectly, through or from any business connection in India then the non-resident entity's business income will not be taxable in India (Mehta, (2014)). If a non-resident entity earns income in terms of a business connection, the entity will be taxed in India (Nishith Desai Associates, 2003:20). The facts of each case must be examined in determining the existence of a business connection (Nishith Desai Associates, 2003:20). If inconsistencies exist between a double tax agreement and a provision in the Income-tax Act, 1961, the provisions in the double tax agreement will prevail (Govind, 2001:193). The following chapter will provide a comparison on the income tax provisions that were discussed on South Africa in chapter 5 and the provisions discussed in this chapter.

CHAPTER 7: COMPARISON OF INCOME TAX LEGISLATION BETWEEN SOUTH AFRICA AND INDIA APPLYING TO OUTSOURCING ARRANGEMENTS

7.1 Background

This chapter analyses those tax provisions that were specifically addressed in chapters 5 and 6, which are similar and different between South Africa and India. A comparison is conducted on the income tax provisions, rates, rebates and thresholds that were discussed in the two previous chapters. A basic tax calculation is provided to indicate the tax payable on South African and Indian sourced income due to a permanent establishment in these countries. A basic tax calculation is also provided to indicate the tax payable by a natural person or individual working in South Africa and India. For comparative purposes for the calculations in this chapter, the exchange rates to be used are as follows:

$ 1 = R 13
$ 1 = Rs 65

7.2 Company

As identified in chapter 2, the requirements for a company to be a resident in South Africa is in terms of para (*b*) of the definition of a resident in s 1 of the Act and in India is in terms s 6(3) of the Income-tax Act, 1961. There are two requirements to be a resident company in both countries of which either requirement can be satisfied. The one requirement is that a company must be formed under the laws of that particular country, which in South Africa is in terms of para (*b*) of the definition of a resident in s 1 of the Act and in India in terms s 6(3)(*i*) read with s 2(26) of the Income-tax Act, 1961. The second requirement is that the place of effective management must be in the relevant country which in South Africa is in terms of para (*b*) of the definition of a resident in s 1 of the Act and in India is in terms s 6(3)(*ii*) of the Income-tax Act, 1961. Initially in India, the second requirement was that the company's affairs are controlled and managed in India. With effect from 1 April 2017, it has changed to the place of effective management requirement (Government of India, 2017:1). The respective South African and Indian corporate residency provisions are similar in the two countries when it

applies to a non-resident entity becoming a resident in either country. Based on these requirements a non-resident entity can become a corporate resident in India as easily as a resident of South Africa.

A resident company of South Africa is taxed on its worldwide taxable income and a non-resident company is taxed on taxable income from sources within South Africa (SARS, 2016:5). A resident company of India is taxed on its worldwide income in terms of s 5(1) of the Income-tax Act, 1961. A non-resident Indian company is taxed on income that is received or is deemed to be received, or accrues or arises or is deemed to accrue or arise in India in terms of s 5(2) of the Income-tax Act, 1961. The basis of taxing a company resident in South Africa is the same as taxing a resident of India as worldwide taxable income is taxed. A non-resident company of South Africa is taxed on a similar concept as a non-resident entity in India as both countries tax a non-resident based on income sourced in the respective country.

The tax rate in South Africa for a company is a flat rate of 28%, irrespective of the residency status of that company (SARS, (2017c)). In India, domestic companies are taxed at 30%, whereas foreign companies are taxed at 40% (Income Tax Department, (2017a)). A domestic company in India is taxed at a higher rate than a company in South Africa. A foreign company in India is also taxed at a higher rate than a company in South Africa. This is significant for an entity that decides to set up a company in a country as a resident company. It is even more significant for a non-resident entity as this entity's tax liability will be less in South Africa than it is in India as indicated in the calculation in 7.7.1 of this chapter.

7.3 Natural person/Individual

In terms of para (*a*) of the definition of a resident in s 1 of the Act and s 6(1) read with s 6(6) of the Income-tax Act, 1961 the respective South African and Indian residency provisions for an individual were examined. In South Africa, the requirements for a natural person to be a tax resident in terms of para (*a*) of the definition of a resident in s 1 of the Act, is based on whether that natural person is ordinarily resident or physically present in South Africa.

Section 6(1) of the Income-tax Act, 1961 also requires that an individual be present in India for a certain length of time. India also has various residency statuses which have been discussed in detail in chapter 2.3.2 (PwC, (2017b)), (KPMG, (2016)). An individual in India is taxed

according to various residency statuses (PwC, (2017b)) in terms of s 5(1) and s 5(2) of the Income-tax Act, 1961:

- Resident and Ordinarily Resident;
- Resident but Not Ordinarily Resident;
- Non-Resident.

Both South Africa and India have tests to determine tax residency of an individual. The term ordinarily resident in South Africa would mean (SARS, 2002:2):

'the country to which a person would naturally and as a matter of course return from his/her wanderings.'

A person can have only 'one real home' and this is where his 'usual or principal residence' is (Clegg and Stretch, 2016:para. 8.3.1). In India the term ordinarily resident has requirements in terms of domestic legislation which actually requires that an individual be present for a certain number of days in India (KPMG, (2016)). Even though the same term is used in India it is not the same concept as that used in South Africa.

To be physically present in South Arica the individual is required to be present in South Africa for a certain number of days as discussed in chapter 2.2.2. In terms of para (*a*)(ii) of the definition of a resident in s 1 of the Act, a person should be present in South Africa for more than 91 days in aggregate during the current year of assessment; more than 91 days in aggregate during each of the five years of assessment preceding the current year of assessment; and more than 915 days in aggregate during those five preceding years of assessment (SARS, 2016:9). A person must meet all three requirements to be considered a tax resident under the physical presence test (SARS, 2016:9). The physical presence test in South Africa is similar to the residency test in India in determining if an individual is Resident and Ordinarily Resident or Resident but Not Ordinarily Resident.

In terms of s 6(1) of the Income-tax Act, 1961 to be a resident in India in any tax year the individual should be in India in that year for a period or periods amounting to 182 days or more; or be present for 60 days or more in that year and 365 days or more during the four years preceding that year (KPMG, (2016)). Section 6(6) of the Income-tax Act, 1961 defines a person to be 'not ordinarily resident' in India in any previous year, if an individual who has been a non-resident in India in nine out of the ten previous years preceding that year, or has during the

seven previous years preceding that year been in India for a period of, or periods amounting to, 729 days or less (KPMG, (2016)).

To be classified as Resident and Ordinarily Resident in India, an individual should comply with either requirement of s 6(1) but not comply with both requirements of s 6(6) of the Income-tax Act, 1961. If an individual complies with either requirement of s 6(1) as well as either requirement of s 6(6), that person is deemed Resident but Not Ordinarily Resident in India (KPMG, (2016).)

The physical presence test is based on a different numbers of days an individual is present in the current year which in South Africa is 91 days (SARS, 2016:9) and India is 182 days (KPMG, (2016)) and in the previous years which in South Africa is 91 days in each of the five preceding year and more than 915 days in aggregate during those five preceding years (SARS, 2016:9) and India is 60 days or more in the current year and 365 days or more during the four years preceding that year (KPMG, (2016)). For an individual working in South Africa the ordinarily resident requirement is likely to apply if South Africa is considered to be the individual's real home or principal residence (Clegg and Stretch, 2016:para. 8.3.1) and the person has an intention and taken steps indicative of the intention to become ordinarily resident (SARS, 2002:4). Unless that individual is working in South Africa for a significantly long time that individual is unlikely to comply with all three requirements of the physical presence test (SARS, 2016:9). In India however, an individual will be become a resident sooner if working on a project for longer than 182 days in the current year (KPMG, (2016)). An individual is more likely to be a tax resident sooner in India than in South Africa as the person will become a resident after 182 days.

From the interpretation of s 5(1) and s 5(2) of the Income-tax Act, 1961 it could be considered to be similar to the definition of gross income in s 1 of the Act where both sets of legislation indicate how income for a resident and non-resident is taxed. A natural person that is a resident of South Africa is taxed on his/her worldwide taxable income and a non-resident is taxed on his/her taxable income from sources within South Africa (SARS, 2016:5). In India, an individual that is resident and ordinarily resident will be taxed on worldwide income. An individual that is resident but not ordinarily resident and a non-resident is taxed on income that is received or is deemed to be received or accrues or arises or is deemed to accrue or arise in India. For an individual that is resident but not ordinarily resident, income that accrues or arises

outside India that is derived from a business controlled in India or from a profession set up in India, will be taxed. (PwC, (2017b).) The basis of taxing an individual for income tax in South Africa and India is similar once the residency status and the source of income has been determined in either country.

South Africa (SARS, (2017a)) and India (Income Tax Department, (2017a)) have a progressive tax rate system applicable to natural persons or individuals. As with companies, South Africa does not have different tax rates for a resident and a non-resident natural person. Both are taxed according to the same tax tables. (SARS, (2017a).) Also, there is no difference in the tax rates for a natural person based on their age as all persons are taxed using the same tax tables. In South Africa the highest tax rate for an individual is 41% which is calculated on taxable income above R 701 301 (SARS, (2017a)). In India, resident individuals are taxed according to their age using different tax tables that have associated age categories (Income Tax Department, (2017a)). The tax table for a non-resident individual is the same as a resident individual below the age of 60 years. (Income Tax Department, (2017a).) In India the highest tax rate for an individual is 30% which is calculated on taxable income above Rs. 1 000 000 (Income Tax Department, (2017a)).

Comparing the highest tax brackets, non-resident individuals that received income sourced in South Africa will be taxed at a higher rate than individuals that receive income sourced in India. Using the exchange rate in 7.1 of this chapter, the highest taxable income in South Africa of R 701 301 is $ 53 946 and in India Rs. 1 000 000 is $ 15 385. Comparing the taxable income in USD, a non-resident individual is more likely to fall into the highest tax bracket in India than South Africa. This is a significant impact on a non-resident individual if the individual receives a modest amount of taxable income, that individual could still fall into the highest tax bracket in India, whereas in South Africa, that individual can fall into a lower tax bracket. The tax rate that is closest to India's rate of 30%, is a rate of 31% in South Africa which is applied on taxable income between R 293 601 – R 406 400 ($ 22 584 - $ 31 261). From this comparison, a non-resident individual after receiving taxable income of $ 15 385 in India will fall into the 30% tax bracket whereas in South Africa an individual will have to receive taxable income of $ 22 584 to fall into 31% bracket. This can once again be favourable for a non-resident individual working in South Africa who will not fall into the highest tax bracket in South Africa but will in India.

Rebates are provided to natural persons in South Africa according to their age and irrespective of their tax residency (SARS, 2016:65). In India, tax rebates are only applicable to resident individuals (Income Tax Department, (2017a)). If a non-resident person works in South Africa and is liable for tax, the person will be at an advantage in South Africa as they will be entitled to a tax rebate. A non-resident person working in India, however will not be entitled to a rebate.

The tax thresholds in South Africa differs depending on the age of the natural person (SARS, 2016:12) and does not depend on the tax residency of the natural person. The tax threshold for person under 65 years is R 75 000 (SARS, (2017a)). Tax thresholds in India also differs depending on the age of the individual (Income Tax Department, (2017a)). The tax thresholds applicable to a resident individual below the age of 60 years and a non-resident individual is the same as examined in chapter 6.5 which is Rs. 250,000 (Income Tax Department, (2017a)). For a non-resident person working in South Africa and India, the thresholds are low in both countries making a person liable for tax. Using the exchange rate in 7.1 of this chapter, the threshold in South Africa of R 75 000 is $ 5 769 for a person under 65 years. The tax threshold for a non-resident in India of Rs. 250 000 is $3 846. Comparing this amount in USD the tax threshold in South Africa is 50% more than the threshold in India. A non-resident individual in India will be liable for tax more easily than in South Africa.

7.4 Permanent establishment/Business connection

As examined in chapter 5.2, in South Africa the Act includes the definition of a permanent establishment which makes reference to the term defined in Article 5 of the OECD *Model Tax Convention* which has been examined in chapter 4.2. In India, a permanent establishment is defined in the Income-tax Act, 1961 but it is only applicable for transfer pricing purposes. The Indian version of a permanent establishment is a business connection. The existence of a business connection it not dependent on the same requirements as a permanent establishment in terms of Article 5 of a double tax agreement. (Mehta, (2014).) The concept of a business connection has been examined in detail in chapter 6.2 of this report. The concept of a business connection is not defined in the Income-tax Act, 1961 but rather an explanation is provided in s 9(1)(*i*) of the Income-tax Act, 1961 (Nishith Desai Associates, 2003:20). The principles for a business connection (Nishith Desai Associates, 2003:22) must be considered as well as the facts of each case (Nishith Desai Associates, 2003:20) in determining if a business connection exists. The principles of a business connection are continuity, real and intimate connection,

attribution of income, common control including a professional connection (Nishith Desai Associates, 2003:22). In the event, a non-resident entity does earn income through or from a business connection in India such income will be taxed in India (Nishith Desai Associates, 2003:20).

A business connection applies in circumstances that are not specifically covered by the definition of a permanent establishment in double tax agreements and the taxation of income is from a transaction between entities where there is no double tax agreement between the two countries (Govind, 2001:190), (Mehta, (2014)). The requirements set out in chapter 4.2 and 4.3 of this report are still relevant in determining if a permanent establishment exists in terms a double tax agreement as this is necessary for the taxation of business profits (Govind, 2001:192). The provisions in the double tax agreement will prevail when there are inconsistencies between a double tax agreement and a provision in the Income-tax Act, 1961, (Govind, 2001:193). The inter-relationship between a business connection and a permanent establishment in India is outside the scope of this report and should be examined on a case by case basis.

In chapter 4.6 the definition of a permanent establishment in terms of Article 5(1) of the South Africa and UK/USA double tax agreements and the India and UK/USA double tax agreements is the same. In such an instance, a non-resident entity will have the same requirements in creating a permanent establishment in South Africa and India. For a non-resident entity, a permanent establishment could be created through an outsourcing arrangement in South Africa and India in terms of Article 5 of a double tax agreement as examined in chapter 4.2 and 4.3. A non-resident entity may have additional tax obligations if a business connection exists in India in terms of Indian tax legislation.

7.5 Assessment period

In terms of South African legislation the year of assessment of a natural person commences on 1 March of a specific year and ends on the last day of February of the following year (SARS, 2016:5). A company has a year of assessment that covers a twelve month period. The year of assessment for a company ends on the same date as the company's financial year-end. (SARS, 2016:6.) In terms of Indian legislation an assessment year for a company and individual commences on 1 April and ends on 31 March of the following year. The year that income is

earned is known as the previous year or financial year. The previous year precedes the assessment year. (KPMG, (2016).) A non-resident individual working in South African or India will have to follow the assessment period in the respective country and must monitor income received. In both countries, an individual working according to the calendar year could receive income that falls into two different assessment periods. For a non-resident company, South Africa allows for a year of assessment that coincides with the financial year which may be favorable to the non-resident company as opposed to India where the assessment year is fixed.

7.6 Double tax agreements

Chapter 4.6 discussed how both South Africa and India have double tax agreements with the UK and USA respectively. In terms of Article 5(1) the definition of a permanent establishment is the same in the double tax agreements that were examined. The difference comes in when examining these double tax agreements with reference to the service permanent establishment provision in Article 5. The South African double tax agreements with the UK/USA refers to a period of 183 days in respect of an entity that renders services in the country which is in terms of Article 5 (3)(b) and Article 5 (2)(k) respectively. The India double tax agreements with the UK/USA refers to a period of 90 days in respect of an entity that renders services in the country which is in terms of Article 5 (2)(k)(*i*) and Article 5 (2)(l)(*i*) respectively. The difference in the number of days in terms of these deemed service permanent establishment articles is significant especially when it comes to creating a service permanent establishment in another country. The time spent by a non-resident entity on certain projects could exceed 90 days and as a result a non-resident can create a permanent establishment more quickly in India than in South Africa.

7.7 Hypothetical tax calculation for a company and individual in South Africa and India

For the purposes of this report a basic calculation will be done to determine the amount of tax a company would pay in South Africa and India as a result of having a permanent establishment. Also, a basic calculation will be done for a non-resident individual that works in South Africa and India. A non-resident company and individual will be taxed in South Africa and India on taxable income that is received from South African and Indian sourced income.

The calculation is based on a nominal amount of $ 100 000 which is then converted to the local currency. This amount is then taxed according to the relevant tax rates to determine the tax payable. The tax amount payable is then converted back to USD to be able to compare the tax payable in South Africa for the 2017 year of assessment and in India for the financial year 2016-2017. Other types of income, exemptions, deductions, capital gains tax, tax credits, surcharges or education taxes were not included in these hypothetical tax calculations, as they do not form part of the scope of this report.

7.7.1 Company

	South Africa	***India***
Taxable Income in USD	$ 100 000	$ 100 000
Converted to local currency	R 1 300 000	Rs 6 500 000
Tax rate	28%	40%
Tax payable	R 364 000	Rs 2 600 000
Tax payable in USD	$ 28 000	$ 40 000

The above calculation provides an analysis of the tax likely to be payable by a non-resident company that has a permanent establishment in South Africa or India. It is noted that a non-resident company in India is taxed more than a company in South Africa as a company in India is taxed at the foreign company rate of 40% as compared to South Africa where a company is taxed at 28%.

7.7.2 Non-resident individual

	South Africa	***India***
Taxable Income in USD	$ 100 000	$ 100 000
Converted to local currency	R 1 300 000	Rs 6 500 000
Tax according to tax tables	R 206 964 + 41% of taxable income above R 701 300	Rs 125 000+ 30% of the excess over Rs. 1 000 000
Tax	R 452 431	Rs 1 775 000
Less tax rebate	(R 13 500)	Rs 0
Tax payable	R 438 931	Rs 1 775 000
Tax payable in USD	$ 33 764	$ 27 308

This calculation provides an analysis of the tax likely to be payable by a natural person or individual which is a non-resident but working in South Africa or India. The tax payable in South Africa is 24% higher than the tax payable in India as the individual is taxed at the highest tax brackets in South Africa and India. From the calculation, this difference is because if an individual earns an income that falls into the highest tax brackets, that individual will be taxed at 41% in South Africa whereas in India that individual is taxed at 30%. The example is in terms of an economically active person that is below the age of 65 years and is liable for tax. Using the exchange rate in 7.1, the assumption is that the individual exceeds the tax threshold in South Africa of R 75 000 ($ 5 769) for a person under 65 years. Also, the non-resident individual will exceed the tax threshold in India of Rs. 250 000 ($3 846). The individual will be eligible for a rebate in South Africa but not in India as the individual is a non-resident. The provision of a rebate is favourable for an individual in South Africa as this reduces the tax payable for a non-resident individual.

In the table below, a basic calculation will be done for an individual working in South Africa or India but earns a modest salary and will have significantly less taxable income.

	South Africa	***India***
Taxable Income in USD	$ 15 000	$ 15 000
Converted to local currency	R 195 000	Rs 975 000
Tax according to tax tables	R 33 840 + 26% of taxable income above R 188 000	Rs 25 000 + 20% of the excess over Rs 500,000
Tax	R 35 660	Rs 120 000
Less tax rebate	(R 13 500)	Rs 0
Tax payable	R 22 160	Rs 120 000
Tax payable in USD	$ 1 705	$ 1 846

From this calculation, the tax payable by a non-resident individual in India is 8% higher than the tax payable in South Africa. This calculation depicts a picture that is more realistic where a junior level resource will be seconded or required to work in South Africa and India. The individual will once again exceed the tax thresholds in both countries. Once again the provision of a rebate is favourable for an individual working in South Africa as this reduces the tax payable for a non-resident individual.

7.8 Conclusion

In both countries, residents are taxed on worldwide taxable income and non-residents on taxable income that is sourced in South Africa (SARS, 2016:5) or India (PwC, (2017b)) respectively.

In South Africa in terms of para (*b*) of the definition of a resident in s 1 of the Act, a company becomes a resident in South Africa if it is incorporated, established or formed in South Africa or has its place of effective management in South Africa. This is similar to the corporate residency provisions in India in terms s 6(3) of the Income-tax Act, 1961 where a company must either be an Indian company or its place of effective management is in India. Based on these requirements a non-resident entity can become a corporate tax resident in India as easily as a tax resident of South Africa. In South Africa a company is taxed at 28%, irrespective of its residency status (SARS, (2017c)) whereas in India a domestic company is taxed at 30%, and foreign companies are taxed at 40% (Income Tax Department, (2017a)). A non-resident entity will pay less tax in South Africa than in India as indicated in the calculation in 7.7.1 of this chapter which is favourable for the non-resident entity.

For an individual to be a resident in South Africa that individual should be ordinarily resident or physically present (SARS, 2016:5). In India, that individual should be physically present in India to be deemed Resident and Ordinarily Resident (KPMG, (2016)). In South Africa, an individual should have an intention and taken steps indicative of the intention to become ordinarily resident (SARS, 2002:4). A similarity that South Africa and India share is that the individual should be present for a certain number of days in the respective country. In South Africa an individual must comply with all three requirements of the physical presence test (SARS, 2016:9) whereas in India an individual can comply with either requirement in s 6(1) of the Income-tax Act, 1961 to become a tax resident (KPMG, (2016)). An individual is likely to become a resident sooner in India than South Africa if working on a project in the current year for more than 182 days (KPMG, (2016)).

For a non-resident individual, the tax payable in South Africa and India depends on the level of taxable income received as indicated in the calculations in 7.7.2. An individual taxed at the highest tax brackets in South Africa and India, will pay 24% more tax in South Africa than in India. In this instance the non-resident will be in a more favourable tax position in India than

in South Africa. If an individual earns a modest amount of taxable income, tax payable by a non-resident individual is 8% higher in India than in South Africa. It must be considered that a non-resident individual will receive a rebate in South Africa (SARS, 2016:65) whereas in India that individual will not (Income Tax Department, (2017a)). This is significant and could be favourable for a person seconded or working in South Africa as the tax payable is reduced by the rebate creating a lower final tax payable.

Tax thresholds in South Africa differ depending on the age of the natural person (SARS, 2016:12) but do not depend on the tax residency of the natural person. Tax thresholds in India also differ depending on the age of the individual and are also applicable to non-resident individuals (Income Tax Department, (2017a)). As indicated in 7.7.2 of this chapter a non-resident person working in India is more likely to exceed the threshold ($3 846) as opposed to an individual in South Africa exceeding the threshold ($ 5 769) when comparing the amount in USD.

In South Africa the year of assessment for a company coincides with the financial year (SARS, 2016:6) and for an individual it starts on 1 March and ends on the last day of February of the following year (SARS, 2016:5). In India, the assessment year for a company and individual is the same which is 1 April to 31 March of the following year (KPMG, (2016)). A non-resident individual has to follow the assessment period in the respective country. A non-resident entity may want flexibility and have an assessment period that coincides with its financial year making South Africa favourable to India in this respect.

In South Africa the definition of a permanent establishment is provided in the Act and makes reference to the term defined in Article 5 of the OECD *Model Tax Convention* which has been examined in chapter 4.2. In India, a permanent establishment is defined in the Income-tax Act, 1961 for transfer pricing purposes only (Nishith Desai Associates, 2003:18). Indian tax legislation refers to the existence of a business connection which is not dependent on the same requirements as a permanent establishment in terms of Article 5 of a double tax agreement. (Mehta, (2014)). The concept of a business connection is explained in s 9(1)(*i*) of the Income-tax Act, 1961 (Nishith Desai Associates, 2003:20). The principles for a business connection (Nishith Desai Associates, 2003:22) must be considered as well as the facts of each case (Nishith Desai Associates, 2003:20) in determining if a business connection exists for a non-resident entity in India in which case such income will be taxed in India (Nishith Desai

Associates, 2003:20). In India, the requirements set out in chapter 4.2 and 4.3 of this report are still relevant in determining if a permanent establishment exists in terms a double tax agreement as this is necessary for the taxation of business profits (Govind, 2001:192).

As indicated in 7.6 of this chapter, in terms of the double tax agreements that were examined the definition of a permanent establishment in terms of Article 5(1) is consistent, making the requirements the same for a non-resident entity creating a permanent establishment in South Africa and India. The significant difference is in the number of days a non-resident can provide services in South Africa (183 days) and India (90 days) in terms of the service permanent establishment provision in Article 5 of the double tax agreements with the UK/USA as indicated in chapter 4.6 and 7.6. A non-resident entity performing services could have a service permanent establishment in a shorter time in India than in South Africa.

CHAPTER 8: CONCLUSION

8.1 Research findings

Globalisation of companies have resulted in multinational companies having a footprint in many other jurisdictions (KPMG, (2014)). South Africa has shown that it is a good outsourcing destination (Deloitte, 2016b:3). It has skilled resources that can be outsourced to the international market (Deloitte, 2015:8, 12). India has skilled resources that provide their services efficiently to satisfied customers (Deloitte, 2015:6). If this was not the case it would not be ranked as the number one outsourcing destination (A.T. Kearney, (2016)). India is also most notably a cheap outsourcing destination (Bakhru & Gupta, (2012)).

A key consideration is whether these multinational companies second or subcontract resources to an entity in a host country and in the process, create a permanent establishment for a parent entity in a host country. The type of outsourcing arrangement entered into between a non-resident entity and an entity in South Africa or India can have significant tax impacts for the non-resident entity. For a secondment arrangement it must be determined who is the economic employer of the secondee. If the non-resident entity is considered to be the economic employer, that resource could create a permanent establishment for the non-resident entity in the host country (Ashley, (2013)). Entering into a subcontracting arrangement can also have a tax implication. If resources of an entity in the home country render services in the host country through a subcontracting arrangement for more than the days stipulated in the double tax agreement between these two countries, a service permanent establishment can still be created in the host country (Morrison, Reilly & West, (2009)).

In the examination of the double tax agreements of South Africa and India with the UK/USA respectively, the deemed service permanent establishment provision in Article 5 must be considered by a non-resident entity performing services in either country. The threshold in India is 90 days in terms of the UK/USA double tax agreements. In South Africa's double tax agreements with the UK/USA, the threshold allowing for a non-resident entity to render services is 183 days. A non-resident entity should monitor the time spent rendering services in either country, as the non-resident entity can create a service permanent establishment in India

in a relatively shorter time than in South Africa especially for services that require ongoing support. In India, a non-resident will also have to consider whether a business connection exists in terms of Indian domestic legislation. In the event, a non-resident entity does earn income in terms of s 9(1)(*i*) of the Income-tax Act, 1961, such income will be taxed in India (Nishith Desai Associates, 2003:20.)

India has different tax rates for a domestic and foreign company where the tax rates are 30% and 40% respectively (Income Tax Department, (2017a)). A discrepancy of 10% in the rates is significant. In both instances, the Indian company tax rates are much higher than the tax rate of 28% in South Africa for companies (SARS, (2017c)).

In terms of the basic tax calculations provided in chapter 7.7.2, an individual taxed at the highest tax bracket in South Africa will be taxed at 41% compared to an individual in India who is taxed at 30%. If the individual earns a more modest amount of taxable income such as $ 15 000 the situation changes. Even though the individual is taxed at 26% in South Africa and 20% in India, the individual will pay 8% more tax in India than in South Africa. This is mainly due to the fact that all taxable individuals receive tax rebates in South Africa irrespective of their tax residency (SARS, 2016:65) whereas in India only resident individuals receive tax rebates (Income Tax Department, (2017a)). This proves more favourable for a non-resident individual working in South Africa through an outsourcing arrangement.

From the comparison done between South Africa and India, the requirements for tax residency, source of income and service permanent establishment requirements are crucial for determining the tax payable in that country. For a non-resident that becomes liable for tax through an outsourcing arrangement, South Africa has been shown to be a more attractive destination from a tax perspective than India in respect of the company tax rate, period of time after which a service permanent establishment is created, provision of tax rebates for all individuals and a lower tax liability for modest taxable income earners.

8.2 Areas of further research

From this report is has emerged that further research may be conducted into the following areas:

- Analyses of transfer pricing provisions associated to the resource's salary during an outsourcing arrangement;
- Examination of other sources of income received by or accrued to a person in South Africa and India, associated withholding taxes and if there are double tax agreement limitations;
- Examination of exemptions, deductions, tax credits and surcharges that are available and applicable in terms of South African and Indian domestic legislation; and
- A comparative analysis of indirect taxes applicable in South Africa and India.

ANNEXURE A: EXTRACTS OF ARTICLE 5 OF THE DOUBLE TAX AGREEMENTS

Countries	*South Africa*	*India*
UK	Article 5(3): The term "permanent establishment" likewise encompasses: (b) the performance of professional services or other activities of an independent character by an individual, but only where those services or activities continue within a Contracting State for a period or periods exceeding in the aggregate 183 days in any twelve-month period commencing or ending in the fiscal year concerned.	Article 5(2): The term "permanent establishment" shall include especially: (k) the furnishing of services including managerial services, other than those taxable under Article 13 (Royalties and fees for technical services), within a Contracting State by an enterprise through employees or other personnel, but only if: (i) activities of that nature continue within that State for a period or periods aggregating more than 90 days within any twelve-month period.
USA	Article 5(2): The term "permanent establishment" includes especially: (k) the furnishing of services, including consultancy services, within a Contracting State by an enterprise through employees or other personnel engaged by the enterprise for such purposes, but only if activities of that nature continue (for the same or a connected project) within that State for a	Article 5(2): The term "permanent establishment" includes especially: (l) the furnishing of services, other than included services as defined in Article 12 (Royalties and Fees for Included Services), within a Contracting State by an enterprise through employees or other personnel, but only if:

	period or periods aggregating more than 183 days in any twelve-month period commencing or ending in the taxable year concerned.	(i) activities of that nature continue within that State for a period or periods aggregating more than 90 days within any twelve-month period.

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