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☞ INTRODUCTION

Over the past few years, the outsourcing industry has transformed the way companies function, with many of them distinctly drawing the line between core and non-core operations to retain the former with themselves and divest the latter to an external entity. With the outsourcing boom, of which India is a major beneficiary, the issue that many overseas companies (**"Foreign Company"**) had been facing for a while was whether the services provided by their Business Process Outsourcing units (**"BPOs"**) would create a Permanent Establishment (**"PE"**) of the parent company in India and thereby subject the global income of the parent company to domestic taxation.

Recently[1], the above issue was put to rest by the Supreme Court of India (**"SC"**) in a landmark judgment of *DIT (International Taxation), Mumbai v Morgan Stanley and Co. Inc*[2] wherein the SC has laid down three important principles: Firstly, the outsourcing of services to a captive service provider will not per se create a PE of the Foreign Company in India, Secondly, deputation activities of persons sent by Foreign Company and not stewardship activities will constitute a service PE[3]. And, finally, the global income of a foreign company cannot be taxed in India by attributing it to its Indian BPO. This month's newsletter analyses the SC judgment by bringing into focus the issues, *ratio decidendi* and implications of the judgment on the outsourcing industry.

1.0 Facts of the case

Morgan Stanley and Company (**"MS & Co."**), a company incorporated in the United States and having several companies in different parts of the world, is an investment bank engaged in the business of providing financial advisory services, corporate lending, and securities underwriting. Morgan Stanley Advantages Services Pvt. Ltd (**"MSAS"**), an Indian company was established by the Morgan Stanley Group to support the group members' main office functions in equity and fixed income research, account reconciliation and for providing IT enabled services such as back office operation, data processing and support centre to MS & Co. Within this framework, MS & Co. outsourced some of its activities to MSAS by way of a service agreement.

As part of the agreement, MS & Co. employees visited India to perform stewardship functions to ensure high standard of quality by MSAS. It also included briefing MSAS staff on various functions and providing basic guidance to meet the overall global benchmark of the Morgan Stanley Group. Further, MS & Co. deputed its employees in MSAS for a period of two years to provide the necessary expertise to the latter's staff. The deputed persons, however, continued to remain employees of MS & Co. and were compensated by them.

The Income Tax (**"IT"**) department had sought to tax MS & Co.'s global income attributable to its Indian BPO, MSAS.

[1] July 9, 2007.
[2] Civil Appeal No. 2914 of 2007.
[3] As per the UN Convention, a service PE is constituted if a multinational enterprise renders services through its employees in India provided the services are rendered for a specified period.

2.0 Issues involved

In light of the above, MS & Co. filed an application before the Authority for Advance Rulings (**"AAR"**) to seek clarity on the taxation of its Indian outsourcing operations and raised the following issues:

- Whether MS & Co. would be regarded as having a PE in India as per the provisions of India-USA Double Taxation Avoidance Agreement (**"DTAA"**)[4] on account of services rendered by MSAS under the service agreement or MSAS being a dependent agent or on account of sending employees to India for stewardship and deputation activities.

- If MSAS is considered to be a PE of MS & Co., would there be anything further attributable to the PE if the PE was compensated on an arm's-length basis?

- Was the method used for transfer pricing between MS & Co. and MSAS the most appropriate method?

Briefly, on the above issues, the AAR on 13.2.2006 held that MSAS was not a fixed place of business of MS & Co. and, therefore, not its PE. Also, since MSAS did not have the authority to conclude contracts on behalf of MS & Co., it did not constitute an agency PE of MS & Co. As regards the service PE issue, AAR held that the presence of employees of MS & Co. in India for more than 90 days and the fact that the employees were performing key managerial activities of MSAS would render MSAS the service PE of MS & Co.

AAR did not rule on the transfer pricing issue in-depth as it considered the issue to be outside its purview and jurisdiction. However, the AAR did hold that no portion of the global profits of MS & Co. would be taxable in India if the Indian company was compensated at arm's-length price. Further, AAR held that the method adopted by MS & Co. in determining the arm's-length price was appropriate.

[4] It is an agreement entered into by two countries so that income earned and taxed in one country is not taxed again in the second country and thus double taxation is avoided.

Aggrieved by the decision of the AAR, both the IT department and MS & Co. filed Special Leave Petitions[5] before the SC. The following grounds were raised at the Supreme Court: Grounds raised by the IT department

- MS & Co. should be regarded as having a fixed place of business in India under Article 5(1) of the DTAA as MS & Co. proposed to carry on its business through MSAS and, thus, is the PE of MS & Co. in India.

- MSAS constituted an *'agency PE'*[6] of MS & Co. under Article 5(4) of the DTAA.

- The AAR erred in holding that once MSAS is remunerated at an arm's-length by MS & Co. then no further income can be attributed to the PE of MS & Co.

Grounds raised by MS & Co.

The AAR wrongly held that the personnel sent by MS & Co. to India on deputation and stewardship constituted a PE under Article 5(2) (l) of the DTAA.

3.0 Decision of the SC

3.1 Whether MSAS is a PE?

The term PE means a fixed place of business through which the business of a Multi National Enterprise (**"MNE"**) is carried on, wholly or partly.[7] A general definition of PE in the first part of article 5(1) postulates the existence of a fixed place of

[5] Article 136 of the Constitution provides that the SC may in its discretion grant special leave to appeal from any judgment, decree, determination, sentence or order in any case or matter passed or made by any Court or tribunal in the territory of India except the Court or tribunal constituted by or under any law relating to armed forces.

[6] Essentially, an agency PE is constituted if an enterprise provides certain services exclusively to its parent company, which is not its usual course of business. In the present case, as per Article 5 (4) of the DTAA, an agency PE could be constituted if MSAS has the authority to conclude contracts on behalf of MS & Co. in India or has no such authority but habitually exercises it or habitually secures orders in India wholly or almost wholly for MS & Co.

[7] Article 5 of the DTAA.

business whereas the second part[8] postulates the places of business, which can constitute a PE.

In order to decide whether the activities undertaken by MSAS consisted of back office operations of MS & Co. and if so whether such operations fell within the ambit of the expression used in the article, the SC took the position that one has to undertake a functional and factual analysis of each of the activities undertaken by the establishment. The SC held that as MSAS was performing only back office operations in India, the second part of article 5 (1) viz. the condition of carrying on business is not fulfilled. Thus, MS & Co. does not have a PE in India as per article 5 (1) of the DTAA. The SC held that as the services performed by MSAS were in the nature of back office operations, they fell under article 5 (3) (e) of the DTAA i.e. preparatory or auxiliary activities carried out at a fixed place of business. Such activities are excluded from the definition of PE. Hence, the SC held that MSAS is not a PE.

3.2 Whether MSAS is an 'agency PE'?

The SC affirmed the AAR ruling that MSAS is not an agency PE of MS & Co. as it had no authority to enter into or conclude the contracts. The SC observed that the contracts would be entered into and concluded in the US with only the back office functions being performed in India. Therefore, it was held that MSAS did not constitute an agency PE.

[8]According to Article 5(2) of the DTAA, PE includes a place of management, branch, office, factory, workshop, mine, oil/ gas well, quarry or a place of extraction of natural resources, warehouse, farm, plantation or related activities (i) a store or premises used as a sales outlet, an installation or structure used for exploration of natural resources, but only if used for a period exceeding 120 days in a year, building site, construction, installation, assembly project or supervisory activities in connection therewith, where such site, project or activities continue for a period exceeding 120 days in any twelve-month period , the furnishing of services other than included services as defined in article 12, by an enterprise through employees or other personnel, but only if (i) activities of that nature continue within that State for a period(s) aggregating to more than 90 days within any twelve-month period or (ii) the services are performed within that State for a related enterprise as defined in article 9.

3.3 Whether MSAS is a 'service PE'?

The SC judgment has clearly drawn a distinction between the two types of activities - stewardship activities and activities of persons deputed by MNE in order to determine whether a particular establishment will be considered as a service PE or not.

Under Article 5 (2) (l)[9] of the DTAA, furnishing of services by employees of a MNE through a fixed place in India can constitute a PE. The present case involved two activities viz. stewardship and deputation. The former entailed briefing of the MSAS staff to ensure that the output meets the requirements of the MS & Co, monitoring of the outsourcing operations at MSAS and basically protecting the interest of the consumers but did not involve day-to-day management functions of MSAS. The SC observed that MS & Co. was "merely protecting its own interests in the competitive world by ensuring the quality and confidentiality of MSAS services". In such a case, it held that there is no 'flow of service from MS & Co. to MSAS' as ruled by the AAR. Thus, the SC held that the stewardship activities of MS & Co. personnel for MSAS would not fall under Article 5 (2) (l) of the DTAA.

On the other hand, the SC upheld the AAR ruling on the issue of deputation of MS & Co. employees in India. The SC observed a service PE is constituted if a MNE renders services through its employees in India for a specified period. The employees would continue to be on the payroll of the MNE and have a lien on their jobs with the MNE. In the present case, the SC observed that every time MSAS would need the expertise of MS & Co., the former would request the latter to depute its staff for a specific period.[10] On completing the tenure, the employees would go back to MS & Co. and continue with their jobs. For all purposes, MS & Co. would retain control over the deputed employees. Therefore, with respect to persons sent on deputation and services rendered by the personnel of MS & Co. to

[9] The term "permanent establishment" includes the furnishing of services other than included services (Royalties and Fees for included services) by an enterprise through employees or personnel but only if the activities of that nature continue in that place for a period(s) exceeding 90 days and if the services are performed in that place for a related enterprise.

[10] In the present case, it was for two years.

MSAS, the SC held that the deputation would constitute a service PE under Article 5 (2) (l). This implies that the portion of income generated by the services rendered by deputationists in India would be taxed at the rate at which foreign companies are taxed in India.[11]

3.4 Income attributable to the PE

The SC relied upon sections 92 A to 92 E of the Income Tax Act, 1961 (**"IT Act"**), which contains transfer pricing provisions, Article 7 of the U.N Model Convention and Article 7 of the DTAA to determine the issue on profits attributable to PE.

The SC observed that not all profits of a Foreign Company having a PE would be taxable in the country where the PE is located. Article 7 of the DTAA clearly stipulates that only that portion of the income of the non-resident enterprise will be taxed, which is attributable to its PE in India. The quantum of the taxable income will be determined in terms of the IT Act. The SC further held that the relevant sections of the IT Act impose an obligation of arm's-length[12] computation of income in international transactions[13] among related parties.

The Court observed that once an arm's-length price has been paid by a non-resident enterprise to its PE in India, nothing further can be attributed to the PE. (*This essentially implies that MS& Co. has to send MSAS the same payment as it would to an outside agency*). So long as the PE has been remunerated on an arm's-length basis taking into account all the risk-taking functions of the MNE i.e. after proper transfer pricing analysis, there will be no further attribution of profits to the PE, and, therefore, no tax will be levied. The SC observed that MS & Co. had remunerated MSAS adequately.

The SC highlighted the role of the IT department in such cases and emphasized that it is their prerogative to ascertain whether the service charges payable or paid to the service provider fully represents the value of the profit attributable to the service. The department has to determine whether the PE has obtained services from the MNE at a correct price (*arm's-length and not lower*). Further, the SC categorically stated that economic nexus is an important feature in determination of profits attributable to a non-resident enterprise through its PE in India.

Finally, the SC observed that MSAS adopted an appropriate method (Transactional Net Margin Method **("TNMM")**)[14] to arrive at a suitable arm's-length to be paid by MS & Co. to MSAS in India.

4.0 Overall analysis

The Morgan Stanley decision is definitely a welcome judgment for the outsourcing industry in India. It will bring respite to several foreign companies which have set-up captive BPOs in India. The crux of the case is that global income of a foreign company cannot be taxed in India by attributing it to its Indian BPO. The SC verdict has cleared the air on the PE status of the BPO units and thereby brought about certainty on their tax treatment in India. The judgment emphasizes the fact that mere presence of a fixed place of business will not render an establishment a PE. Had the SC rendered the BPO as a PE then profit in respect of activities carried on by the BPO in India would have been subject to tax approximately at the rate of 42%. Since the SC has ruled to the contrary, there is no such tax implication for BPOs in India.

By drawing a line between stewardship and deputation activities, the SC has clarified the tax treatment of these activities. This distinction will enable the Foreign Company to carefully carve out their 'personnel' structure in future so as to avoid the tag of a service PE, for in that case, the income (generated owing to the deputation services) of the Foreign Company will be taxed at the rate at which

[11] Presently, the rate is about 42%.

[12] Essentially, it means the price at which a buyer and an unrelated seller would freely agree to transact or a trade between related parties that is conducted as if they were unrelated, so that there is no conflict of interest in the transaction.

[13] Section 92 B of the IT Act defines international transaction to mean a transaction between two or more associated enterprises which are, either or both of whom are non-residents and covers purchase, sale or lease of tangible, intangible property and has a bearing on profits, income, losses or assets of such enterprises.

[14] Section 92 C (1) of the IT Act provides five methods for computing the arm's-length price. The method to be adopted for this purpose depends on the facts and circumstances of each case.

foreign companies are taxed in India (i.e. at about 42%). However, the distinction of activities also gives rise to a concern as to how will the income attributable to deputation activities be segregated from the rest of the income. The BPOs will be required to maintain proper records to clearly indicate the purpose of visit of each personnel.

It is possible for the foreign companies to circumvent the 'service PE' label. As per the SC's ruling, the employees sent by the Foreign Company are on the Foreign Company's pay-rolls, have a lien with it, and are controlled by it meaning thereby that the Foreign Company has control over the employment terms of the persons sent to the BPO for the stipulated time period. This, according to the SC, gives rise to the concept of a service PE. However, it can be argued that if the BPOs can show that the employees are entered on their and not the Foreign Company's pay rolls, have a lien with them, and are controlled by them rather than the Foreign Company, service PE is not created. In the present case, the personnel were deputed for two years. They were paid by MS & Co. and controlled by them. If the persons are employed as MSAS's employees, then they can avoid the 'service PE' tag. For a term shorter than three months, it may not be feasible but for longer duration, companies can do this to avoid payment of tax at high rates.

The most important impact of the verdict is that it has ended the ambiguity surrounding the taxation of captive BPOs in India. As a result of this decision, the Foreign Company will no longer be at risk of being taxed in India as long as it compensates its outsourcing unit on an arm's-length basis. If the transfer pricing analysis undertaken to determine the arm's-length price does not adequately reflect the functions and risks of the Foreign Company then, in that case, the functions/risks that have not been considered, will be attributable to the PE. Companies adopt a suitable accounting method to arrive at arm's-length price. For this purpose, they take into account various factors, which reflect the functions, risks of the company in terms of its transaction vis-à-vis related and unrelated parties. If the arm's-length price does not adequately cover these factors by making the necessary adjustments then such functions/risks/factors can be attributed to the PE. For example, in TNMM, the net profit margin realized by an enterprise from a related party transaction is computed in relation to costs incurred or sales effected or assets employed or to be employed by the enterprise or having regard to any other relevant base. The net profit margin realized by the enterprise or by an unrelated enterprise from a comparable uncontrolled transaction or a number of such transactions, is also computed having regard to the same base. This margin is adjusted to take into account the differences (if any) between the related party transaction and the comparable uncontrolled transactions or between the enterprises entering into such transactions, which could materially affect such net profit margin in the open market. The cost of production referred to above increased by the adjusted profit mark-up is taken as arm's-length price. The adjusted net profit margin is taken as arm's-length price[15].

☞ CONCLUSION

India is considered to be a prime outsourcing destination. The vast pool of English-speaking workforce, technically sound, large population of graduates, the distinct advantage in terms of time zone, and the cost effective benefit that it offers makes it a sought after BPO location. The latest SC verdict will come as a breather to foreign companies and will provide the necessary assurance and confidence to them in operating through their captive BPOs in India, which in turn will provide a fillip to the already fast growing Indian BPO industry.

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[15] Rule 10B(1) (e), section 92C of the Income Tax Act, 1961.

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