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India: High Court upholds advance ruling – secondment results in provision of services

Background

- The applicant Centrica India Offshore Private Limited (CIO), an Indian Company, is a wholly owned subsidiary of Centrica Plc, UK.
- Centrica Plc, and its other overseas subsidiaries in the UK and Canada, outsourced their back office support functions to third-party vendors in India.
- CIO was set up to provide a locally based interface between the overseas entities and the Indian service providers and received service charges at cost plus 15% under a service agreement with the overseas entities.
- A secondment agreement was simultaneously entered into between CIO and the overseas entities under which employees of the overseas entities were seconded to Centrica India.
- CIO was to bear all the costs of the monthly remuneration of the secondees, which the overseas entity would recharge to CIO on a monthly basis.
- CIO had approached the Authority for Advance Rulings (AAR) to determine the following:
    - Whether the amount paid by CIO to the overseas entities under the secondment agreement is in the nature of income accrued to the overseas entities.
    - If yes, whether tax is liable to be deducted at source by CIO on such payments.

AAR ruled against CIO and held that:

- Reimbursement of salary cost was in the nature of income accrued to the overseas entities;
- Services rendered by the seconded employees were managerial in nature but would not be covered by Article 13.4 of the India-UK Double Taxation Avoidance Agreement (DTAA) or Article 12.4 of the India-Canada DTAA, which deals with fees for technical services;
- Consideration paid to the overseas entities were not “fees for technical services”;
- The overseas entities constituted service PE under the relevant DTAA on account of employees deputed by them under the terms of the secondment agreement; and
- Tax is liable to be deducted at source on the amount paid/payable by CIO to the overseas entities.

Aggrieved by the decision of the AAR, CIO filed a writ petition with the Delhi High Court.

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Issues before the Delhi High Court

1. Whether secondment of employees by the overseas entities to CIO falls within Article 12 of the India-Canada DTAA and Article 13 of the India-UK DTAA; whether the overseas entities rendered "technical services"/included services under the respective Articles, such that a tax liability arose on account of provision of services.
2. To address the following arguments of CIO in the context of whether the AAR was right in holding that secondment of employees leads to a service PE for the overseas deputing entity:
    a. There is no service PE since CIO is the economic employer while the overseas entities are only the legal employer.
    b. The payment made by CIO represents a reimbursement, which does not form a part of the income of the overseas entities.
    c. The payment is not the income of the overseas entities on account of the doctrine of diversion of income by overriding title.

Observations and Ruling of the Honorable High Court

The Delhi High Court decided against the petitioner on the following grounds.

Fees for technical services –

- The India-UK DTAA defines "fees for technical services" as "payments of any kind of any person in consideration for the rendering of any technical or consultancy services (including the provision of services of a technical or other personnel)". In this case, the overseas entities have, through the seconded employees, provided "technical" services to CIO since the expression expressly includes the provision of services of personnel.
- Technical services does not limit itself only to technological services, but rather, extends to know-how, techniques, and technical knowledge.
- Article 12 of the India – Canada treaty incorporates fees for "included services." While this includes technical services and consultancy service', the second qualification under the definition for technical knowledge to be made available is an essential and additional requirement of the DTAA. The activity of the secondees is to transfer their technical ability to ensure quality control vis-à-vis the Indian vendors, or in other words, make available their know-how of the field to CIO for further consumption. The secondment, if viewed from this angle, actually leads to a benefit that transmits the knowledge possessed by the secondees to the regular employees. Article 12 contemplates not only a formal transfer of intellectual property, but also other techniques and skills. The skills and knowledge required to ensure that the task entrusted to CIO – quality control – is carried out diligently falls within the relevant article of the said treaty.
- There is no distinction between the provision of services by the overseas entities and the mere secondment of employees, since the services provided by the overseas entities are the provision of technical services through the secondees.

Service PE –

- Seconded employees retained their entitlement to participate in the overseas entities retirement and social security plans and other benefits as applicable to them. The salary was also payable by the overseas entities.
- There was no document to substantiate that the secondees could terminate the secondment arrangement.
- Documents submitted did not reflect that the salary costs of the secondees is to be borne by CIO.
- Secondees cannot sue CIO for default in payment of their salary; no obligation is spelled out vis-à-vis CIO.
- CIO has the right only to terminate the secondment in its agreement with the overseas entities and not the services of the secondee vis-à-vis the overseas entities vide the original subsisting employment relationship, which remained independent and beyond the control of CIO.
- The concept of legal and economic employer as considered by Vogel was distinguished. The Court recognized that the secondees were originally employees of the overseas entities and not hired as a false façade, whose productivity is to be ultimately traced to CIO, and that they were seconded for a limited period of time to CIO to utilize their technical expertise.
- The employment relationship between the overseas entities and the secondees is at no point terminated, nor was CIO given any authority to even modify the continuing relationship.
- Salary ultimately paid through the overseas entity, which is not a mere conduit.

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- CIO may have operational control over these persons and may be responsible for their failures, but these factors cannot displace the larger and established context of employment abroad.
- The services are not in the nature of stewardship, and the overseas entities continue to be the real employer.
- The decision of the Supreme Court in the case of Morgan Stanley supports the view of the AAR on service PE.
- The OECD Commentary on Article 15, which distinguishes a situation where the employee works exclusively for the enterprise in the state of employment and is released for the period by the enterprise in the state of residence, was clearly and critically not done in this case.
- The ruling in AT & S India Private Limited (AT & S) would be applicable to the case on hand, wherein it was held that the payments were not in the nature of a reimbursement. The nature of the transaction determines taxability or otherwise and not the nomenclature used to describe it or the absence of a markup on costs.
- The obligation of the overseas entities to pay the seconded employees is independent of the arrangement between the former and CIO and hence doctrine of "diversion of income by overriding title" would not apply to the payments made by CIO.

Deloitte's comments

The transfer of employment through a secondment arrangement has virtually been struck down by the court in the instant case. Deputations under such arrangements may result in a tax liability for the overseas entity on account of payments made on recharge of salary costs on secondments. Companies will be well advised to review their secondment arrangements in the light of the above ruling to determine whether the employees seconded to an Indian company result in a taxable service by the seconding entity.

The High Court has held that the payments made by CIO to the overseas entities would fall within the provisions of Articles 12/13 on fees for technical services. At the same time, the Court, by rejecting the arguments put forth by CIO against service PE, appears to have indirectly concluded that secondment of employees would create one. In upholding the ruling of the AAR, the Court has not independently analyzed Article 5 on PE. It is pertinent to note that Article 5 of the respective DTAAs specifically excludes constitution of PE with respect to services that are taxable under Articles 12/13 on fees for technical services. Hence, one may have to read this decision in tandem with the AAR ruling to get a complete picture.

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Global Rewards Updates:
Australia: Securities law – new Class Order

Background

Securities laws in Australia are administered by the Australian Securities and Investments Commission (ASIC). An offer under an employee share plan would generally need to be accompanied by a disclosure document to ASIC, unless the offer is exempt under either a statutory or administrative exemption.

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If the shares offered under a plan are shares quoted on a foreign stock exchange and are offered only to employees, the plan would normally be exempt from these filing requirements under the ASIC Class Order 03/184. In order to benefit from this exemption, the company would still be required to meet certain conditions.

New class order

ASIC is in the process of updating Class Order 03/184 with a proposed new Class Order and has stated that it intends to adopt the new Class Order in May 2014.

It is anticipated that the requirements that a plan must meet in order to be exempt under the new Class Order will replicate those under Class Order 03/184, summarized below. In addition:

- At least 25% of the awards must not vest for at least 12 months; and
- Instead of requiring a copy of the offer document to be filed with ASIC, a form setting out limited details in relation to the offer must be lodged with ASIC within 7 days from the date on which the offer documents were first provided to an employee in Australia.

The requirements that must be met under both the existing and the proposed new Class Order are:

- The offer under the plan must be in writing and be accompanied by a copy or summary of the plan rules (the 'offer document');
- The offer document must specify the offer price (in Australian currency) of the shares to which the offer relates. The document must also include an undertaking that the employer will provide the employee with information relating to shares in the same class as those offered and the market price of the shares within a reasonable time;
- The offer must be for the issue of fully-paid shares in an issuer in the same class as shares which have been quoted on an approved exchange throughout the 12 month period immediately before the offer without suspension for more than a total of 2 trading days during that period; and
- The total number of shares in the same class issued under employee share plans during the previous five years must not exceed 5% of the total number of issued shares in that class.

Action

If you have previously relied on the exemption under Class Order 03/184 then you should review your plan rules to check if they will meet the new requirement (i.e. 25% of awards will not vest in the first 12 months). If they do not, then alternative approaches are available.

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Global Rewards Updates:
France: Changes to rules for awarding qualified free shares

Background

Until recently, the allocation of qualified free shares was not subject to any legal constraints in France, unless shareholders decided otherwise. Additionally, companies could award free shares within the limit of 10% (or 15% for non-listed companies) of the company's ordinary share capital. However, law n°2014-384 of March, 29th 2014, has introduced an allocation ratio between the largest and smallest awards of free shares and has also increased the maximum amount of free shares that can be awarded as a percentage of ordinary share capital. The new rules are applicable to awards granted on or after 2 April 2014.

Please note that these new provisions only apply to qualified free shares (i.e. no similar provisions have been introduced for qualified share options or non-qualified share plans).

Introduction of allocation ratio for awards of qualified free shares

The difference between the number of qualified free shares awarded to each participant may not exceed a ratio of 5:1. For example, in a group of employees, where one employee receives 100 free shares, no other employee may receive more than 500 free shares.

The scope of these new rules needs to be defined and clarified as it is not clear whether the new allocation ratio will apply for both all employee plans and discretionary plans. We will provide more information on this as it becomes available.

Increase to the maximum volume of qualified free shares that can be awarded

The new law has also increased the limit of the total amount of qualified free shares that can be granted to 30% of the company's ordinary share capital (regardless of whether the company is listed or non-listed). This new limit only applies where the free shares are granted to all employees. Therefore, if the free shares have not been granted to all employees, the limit remains at 10% (or 15% for non-listed companies) of the company's ordinary share capital.

This new law aims to provide companies with tools to fight against hostile takeovers, and to encourage employee shareholding.

Action

Companies making grants of qualified free share awards now should consider whether they may potentially be in scope of the new rules.

As the scope of these rules is unclear, it is recommended that a case by case approach based on the specific facts is undertaken.

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