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GES Alert

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Mumbai Tribunal holds that employee deputation results in Service PE and salary reimbursements are taxable as business profits

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Facts

- M/s Morgan Stanley International Incorporated (“the assessee”) is a resident of USA and 100 percent subsidiary of M/s Morgan Stanley USA.
- The assessee is engaged in the business of providing support services to various subsidiaries of M/s. Morgan Stanley USA both in and outside India.
- During the tax year 2004-05, the assessee had entered into an agreement with M/s J M Morgan Stanley Securities Private Limited, an Indian Company for providing support services.
- The assessee had seconded five of its employees to M/s Morgan Stanley Advantages Services Pvt. Ltd. (MSASPL) and M/s MISM Global Support and Technology Services Pvt. Ltd (GSTSPL), its Indian subsidiaries to work under the supervision and control of the Board of Directors of the said companies.
- The seconded employees were paid salary by the assessee merely for administrative convenience and after deduction of applicable taxes under Section 192 of the Income Tax Act, 1961 (Act).
- The assessee recharged the salary costs onto the Indian subsidiaries without any mark up.
- The Assessing Officer (AO) held that the real business of the assessee is to provide managerial and consultancy services and accordingly the reimbursement of salary costs was nothing but fees for technical services (FTS) both under section 9 (1)(vii) of the Act and Article 12 of India – USA Double Taxation Avoidance Agreement (DTAA).The reasoning of the AO were:
  - Employees deputed to India are highly qualified and technical persons offering special services to the Indian subsidiaries which is expected to be utilized in India
  - There is no secondment agreement between the assessee and the Indian subsidiaries and the assessee is responsible for the review, discipline, promotion, appraisal and all other HR and administrative matters of the deputed employees
- The Commissioner of Income-tax (Appeals) (CIT(A)) upheld the action of the AO in treating the reimbursement of salary cost as ‘fees for technical services’. The CIT (A) observed that
  - The assessee failed to demonstrate with evidence that the cost incurred by the foreign company has been reimbursed ‘as such’ by the Indian companies and
  - There is no secondment agreement and the Indian company cannot remove the employees deputed to India.

- Aggrieved by this Ruling, the assessee approached the Mumbai Tribunal.

Issues before the Tribunal

- Whether the assessee has rendered services to the Indian Companies - MSASPL and GSTSPL through the seconded employees?
- Whether the reimbursement of salary cost received by the assessee is taxable as 'Fees for Technical Services' under the provisions of Section 9(1) (vii) of the Act / Article 12 of the DTAA?

Ruling of the Tribunal

The Tribunal has held that the seconded employees who render services in India on behalf of the assessee will constitute a service PE. As a result, the salary costs reimbursed to the assessee are taxable as per Article 7 (Business Profits) and not Article 12 (Royalty & Fees for included services). It has proceeded on the premise that the seconded employees are the real employees of the assessee who have come to India to render services for arriving at the above conclusion. The Tribunal has also made the following observations:

- Under a classic secondment agreement, employees who are under employment of non-resident parent are deputed or transferred to subsidiary company in the overseas countries to work for special assignments which are more technical and managerial in nature;
- Such deputation is mainly for the benefit of the subsidiary company to smoothly and effectively conduct its business;
- The seconded employees usually work under the direct control and supervision of the subsidiary entities;
- Since these employees belong to the main parent entity, they continue to receive their remuneration with all social security benefits from the parent entity; Though legally they remain the employees of the parent entity, the subsidiary entity is the economic employer of the seconded employees, which ultimately bears the salary cost, exercises control over the

work and has the power to remove them

- Para 6 of Article 12 of the Tax Treaty between India and USA clearly states that Article 12 shall not apply to determine the taxability of “royalty” and “fees for included services” where the resident of a contracting state (USA) carries on the business in other contracting state (India) in which FIS arises through PE situated therein. In such situations, taxability of income shall be governed by the provisions of Article 7, i.e. Business Profits. To this extent, the decision of Delhi High Court in Centrica does not apply wherein salary reimbursements were held taxable as fees for technical services without referring to the exclusionary clause 12(6) of the DTAA.
- While computing the business profits of the PE in India as per the provisions of Article 7 of the DTAA, payment received by the assessee is to be treated as revenue receipt and salary paid by the assessee is to be considered as cost to the assessee and be allowed as deduction.

The Tribunal directed the Assessing Officer to compute the income accordingly.

Comments

The Tribunal observation distinguishing legal employment vis-à-vis economic employment is a welcome move. However, by holding that the employees were the real employees of the assessee, the Tribunal has not factored the above observation as also the principles of secondment in its final ruling. Nevertheless, it has provided a clear direction that where a PE is established, the associated income has to be taxed as business profits rather than fees for technical services. This would naturally lead to a question on the quantum of income to be attributed to the service PE.

Though the ruling makes a reference to the Delhi High Court ruling in the case of Centrica India Offshore (P.) Ltd[1] and the Supreme Court decision in the case of Morgan Stanley & Co.[2], it is not clear how these rulings have been applied to come to the conclusion that the employees were the “real employees” of the assessee.

In recent times, Indian tax authorities seem inclined towards Service PE in case of secondment of employees. This reiterates the need for critical review and assessment of the secondment arrangements.

Source: Morgan Stanley International Incorporated vs Dy. Director of Income Tax I .T.A. No.6882/Mum/2011

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

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

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Contacts

Ahmedabad
Heritage, 3rd Floor,
Near Gujarat Vidyapith,
Off Ashram Road,
Ahmedabad – 380 014.
Tel: + 91 (079) 2758 2542
Fax: + 91 (079) 2758 2551

Bangalore
Deloitte Centre, Anchorage II,
100/2, Richmond Road,
Bangalore 560 025.
Tel: +91 (080) 6627 6000
Fax: +91 (080) 6627 6010

Chennai
No.52, Venkatanarayana Road,
7th Floor, ASV N Ramana Tower,
T-Nagar,
Chennai 600 017.
Tel: +91 (044) 6688 5000
Fax: +91 (044) 6688 5050

Coimbatore
Shanmugha Manram
41, Race Course,
Coimbatore
Tamil Nadu - 641018
Tel: + 91 (0422) 439 2801
Fax: +91 (0422) 222 3615

Delhi/Gurgaon
Building 10,
Tower B, 7th Floor,
DLF Cyber City,
Gurgaon 122 002
Tel : +91 (0124) 679 2000
Fax : + 91 (0124) 679 2012

Hyderabad
1-8-384 and 385, 3rd Floor,
Gowra Grand S.P.Road,
Begumpet,
Secunderabad – 500 003.
Tel: +91 (040) 6603 2600
Fax:+91 (040) 6603 2714

Kolkata
Bengal Intelligent Park Building Alpha,
1st floor, Block EP and GP Sector V,
Salt Lake Electronics Complex,
Kolkata - 700 091.
Tel : + 91 (033) 6612 1000
Fax : + 91 (033) 6612 1001

Mumbai
Indiabulls Finance Centre,
Tower 3, 28th Floor,
Elphinstone Mill Compound,
Senapati Bapat Marg, Elphinstone (W),
Mumbai – 400013
Tel: + 91 (022) 6185 4000
Fax: + 91 (022) 6185 4101

Pune
106, B-Wing, 7th Floor,
ICC Trade Tower,
Senapati Bapat Road,
Pune – 411 016.
Tel: + 91 (020) 6624 4600
Fax: +91 (020) 6624 4605