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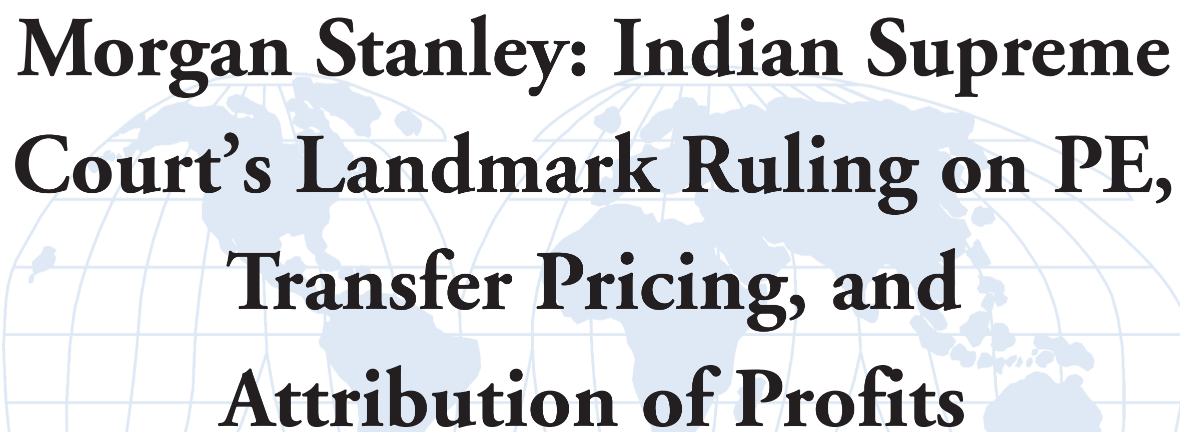

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by Jitender Tanikella and Bijal Ajinkya

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Morgan Stanley: Indian Supreme Court's Landmark Ruling on PE, Transfer Pricing, and Attribution of Profits

by Jitender Tanikella and Bijal Ajinkya

The Supreme Court of India on July 9 delivered a landmark judgment in the case of *DIT (International Taxation), Mumbai v. Morgan Stanley and Co. Inc.,*[1] ruling that the outsourcing of services such as back-office operations to a captive service provider will not per se create a permanent establishment of the parent in India. (For prior coverage, see *Doc 2007-16093* or *2007 WTD 133-2*.)

With that judgment, the Supreme Court has laid down the difference in tax treatment between persons performing a stewardship function in relation to the deputation of employees. It has also accepted the single-entity approach for the attribution of profits to a PE by ruling that the payment of an arm's-length price by the nonresident to the PE extinguishes any further attribution of profits to tax. And it has reiterated the importance of considering an economic nexus before taxing a nonresident's global profits in India.

The outsourcing industry around the world has been confronted of late with the contentious question of whether outsourced services provided by companies — particularly by captive service providers/manufacturers — would cause a PE of the nonresident service recipient to come into existence under the terms of the relevant tax treaty. India has been a major beneficiary in the outsourcing boom, and, hence, If Indian tax authorities were to hold that such activities are tantamount to a PE, the global profits attributable to the PE would be taxable in India at the rate of 42.23 percent.[2] Further, the availability of a tax credit in the home jurisdiction for such tax paid in India would be uncertain, potentially leading to double taxation and wiping out the economic advantage of outsourcing to India. On the other hand, if no PE exists, no profits can be subjected to Indian corporate tax.

Morgan Stanley & Co. U.S., (MS & Co.) is a U.S.-based leading investment bank. As is the case with many other multinationals, MS & Co. outsources a wide range of high-end support services to a captive group company — in this case, Morgan Stanley Advantage Services Private Limited (MSAS) in India. Last year, India's Authority for Advance Rulings (AAR) ruled on an application by MS & Co. that the activities of MSAS would not constitute a PE of MS & Co. in India, other than for stewardship and deputation activities.[3] The Indian tax authorities filed a special leave petition (similar to an appeal) before the Supreme Court, challenging that ruling.

In its judgment, the Supreme Court has reaffirmed the ruling of the AAR in that regard and has also held that stewards do not constitute a PE. The judgment is a respite for the outsourcing industry as a whole, and has tremendous implications, especially for the emerging KPO (knowledge process

[1] Civil Appeal No. 2914 of 2007 (arising out of S.L.P. (C) No. 12907 of 2006) and Civil Appeal No. 2915 of 2007 (arising out of S.L.P. (C) No. 16163 of 2006).

[2] Inclusive of the applicable surcharge and cess (education tax).

[3] *Morgan Stanley and Co. 2006 ITR* (284) 260.

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outsourcing) industry, and for outsourced research and development and contract manufacturing.

The Supreme Court's decision is important for reasons that extend beyond the facts of this particular case, as the judgment includes discussions of several important aspects of international tax law, which are discussed in more detail below.

Facts of the Case

MS & Co. is incorporated in the United States and is in the business of providing financial advisory services, corporate lending, and securities underwriting services. MS & Co. has a number of group companies in various parts of the world. MSAS is an Indian private limited company set up by the Morgan Stanley Group to support the group members' front office and infrastructure unit functions in their global operations. The support services to be rendered by MSAS broadly cover functions such as information technology support, account reconciliation, research support, and so on. Within that framework, MS & Co. outsourced some activities to MSAS by way of a service agreement. MS & Co. proposed sending some personnel to India to undertake stewardship activities to enforce quality control standards. Also, some personnel would be deputed to MSAS and would work under the supervision and control of MSAS.

To obtain clarity on the taxation of its Indian outsourcing operations, MS & Co. filed for the tax ruling by the AAR, raising the following questions:

- Does MS & Co. have a PE in India under the India-U.S. income tax treaty by virtue of MSAS being regarded as its fixed place of business or as a dependent agent, or constituting a service PE on account of personnel sent for stewardship or deputation of its personnel to MSAS?
- Was the method used for transfer pricing between MS & Co. and MSAS the most appropriate method, and was the price paid at arm's length?
- If it is held that there is a PE in India, would there be anything further attributable to the PE if the PE was compensated on an arm's-length basis?

The AAR held that the captive service provider (MSAS) is not a fixed place of business PE of MS & Co., as it is not the business of MS & Co. that is carried out from there. The AAR also held that MSAS does not constitute an agency PE of MS & Co. because it does not have the authority to conclude contracts on behalf of MS & Co.

Regarding the exposure to a service PE on the proposed assignment of personnel for stewardship or the deputation of personnel, the AAR held that the presence of employees of MS & Co. for more than 90 days would constitute a service PE in India.

The AAR also held that no portion of the global profits of MS & Co. would be taxable in India if the Indian company (PE) was compensated at arm's length. The AAR relied on Indian tax authorities' Circular 23 of 1969 and Circular 5 of 2004 in that regard and held that an arm's-length payment extinguishes any further profits that may be sought to be attributed to the nonresident.

The AAR did not rule on the transfer pricing questions on the grounds that it is precluded under the Indian Income Tax Act (ITA) from giving a ruling on an issue that is under consideration by the tax authorities. That was a stringent view, as tax officers have been instructed to scrutinize all international transactions involving amounts in excess of INR150 million (approximately US $3.7 million).

Grounds Before the Supreme Court

The Indian income tax authorities, aggrieved by the ruling of the AAR, in May 2006 filed a special leave petition (SLP), a sort of appeal, with the Supreme Court, to which MS & Co. cross-appealed. The main issues raised by the Indian tax authorities were whether MS Co. has a PE in India under the terms of article 5 of the India-U.S. tax treaty, and if so, whether the payment of arm's-length remuneration by MS Co. to MSAS extinguishes its tax liability in India.

Supreme Court's Ruling

The Supreme Court closely examined the Indian tax authorities' contention regarding the existence of a PE of MS & Co. in India by virtue of the performance of outsourced activities by MSAS. The Court observed that to decide whether a PE was constituted, there must be a functional and factual analysis of each of the activities to be undertaken by the establishment. Importantly, the Court observed that under article 5(1) of the treaty, a PE of a multinational enterprise would come into existence in India only if there is a fixed place in India through which the business of the multinational enterprise is wholly or partly carried on.

Fixed Place of Business PE

The Supreme Court noted that MSAS in India would be engaged in supporting the front office functions of MS & Co. in fixed income and equity research and in providing IT-enabled services such as data-processing support, technical services, and reconciliation of accounts. Accordingly it held that article 5(1) of the treaty is not applicable, as MSAS would be performing only back-office operations, which in the mind of the Supreme Court could not be

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construed as the business of the multinational enterprise, thus failing to satisfy article 5 (1) in its entirety.

The Supreme Court held that the services performed by MSAS, being in the nature of back-office functions, fall under article 5(3)(e) of the treaty, which excludes activities of a preparatory or auxiliary character (even when performed out of a fixed place of business) from constituting a PE.

Agency PE

The Supreme Court also affirmed the AAR's ruling that there is no agency PE, as MSAS in India had no authority to enter into or conclude contracts on behalf of MS & Co. In that regard, the Supreme Court observed that while the contracts would be entered and concluded in the United States, only the implementation of those contracts (to the extent of back-office functions) would be carried out in India.

Service PE Deputation

Regarding the services rendered by personnel of MS & Co. on deputation to MSAS, the Supreme Court held that the deputation would constitute a PE within the terms of article 5(2)(l) of the treaty (service PE).

Under article 5(2)(l) of the treaty, even a single day in which services are furnished by employees of a nonresident enterprise to a related enterprise through a fixed place in India can constitute a PE. The Supreme Court observed that an employee of MS & Co., when deputed to MSAS, does not become an employee of MSAS. The deputed employee has a lien on his employment with MS & Co. and as long as the lien remains with MS & Co., the parent company may be considered to retain control over the deputed employee's terms and employment, the Court said. Thus, the deputed person cannot be considered as an employee of MSAS. The Court then found that when the activities of a multinational enterprise entail it being responsible for the work of deputed employees and the employees continue to be on the payroll of ″the multinational enterprise or they continue to have their lien on their jobs with the multinational enterprise," a service PE can emerge.

Further, the Court appears to have taken into consideration that the request/requisition for the deputation of employees with specialized skills generally comes from MSAS. Furthermore, MS & Co. retains a degree of control and supervision over the employees to the extent they remain on MS & Co.'s payroll, and any disciplinary action against them may not be taken by MSAS without consultation with MS & Co. The services are not for MS & Co., but are for and to MSAS. Therefore, because the deputed employee remains an employee of MS & Co. and is providing services to and for MSAS, a service PE is created under the terms of article 5(2)(l) of the treaty. Stewardship

The Supreme Court also held that personnel of MS & Co. engaged in stewardship activities for MSAS would not constitute a service PE of the parent company in India, hence overturning that aspect of the AAR's ruling. The Supreme Court observed that a service recipient such as MS & Co. that has worldwide operations is entitled to insist on quality control and confidentiality from the service provider. Furthermore, a service provider may also be required to act according to the quality control specifications imposed by its customer.

Thus, it held that because the object of the employees of MS & Co. sent as stewards was primarily to protect the interest of MS & Co., it could not be said that MS & Co. had been rendering the services to MSAS. In the words of the Supreme Court, MS & Co. "is merely protecting its own interests in the competitive world by ensuring the quality and confidentiality of MSAS services."

Income Attributable to a PE

The Supreme Court also found that once an arm's-length price has been paid by a nonresident enterprise to its PE in India, nothing further can be attributed to the PE. The Supreme Court observed that sections 92-92E of the ITA (the transfer pricing provisions) impose an obligation of arm's-length computation of income in international transactions among related parties. The Court noted that the transfer pricing provisions were enacted to prevent the shifting of profits outside India. Further, the Court referred to article 7 of the treaty, under which it is the income of the nonresident enterprise attributable to the PE that is taxable, and made the significant observation that economic nexus is an important feature of any such profit attribution exercise.

Regarding the attribution of further profits to the PE of MS & Co, the Court held that the AAR ruling was correct in principle, provided the PE is remunerated on an arm's-length basis, taking into account all the risk-taking functions of the multinational enterprise. Thus, once a proper transfer pricing analysis is undertaken, there should be no further need to attribute profits to a PE.

In the context of the service PE, the Court held that the entire exercise ultimately is to ascertain whether the service charges payable or paid to the service provider fully represent the value of the profit attributable to the service. However, the Court noted that it is for the Indian tax authorities to examine whether the PE has obtained services from the multinational enterprise at a lower-than-arm's-length cost. Therefore, the Indian tax authorities

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have to determine income, expense, or cost allocations regarding arm's-length prices to decide the proper application of the transfer pricing regulations.

Transfer Pricing Method

The Supreme Court noted that section 92C(1) of the ITA, along with the rules framed thereunder, provides as many as five methods for computing the arm's-length price (namely the comparable uncontrolled price method, the profit-split method, the resale price method, the cost-plus method, and the transactional net margin method). In that regard, the Court noted that the transfer pricing study to determine the arm's-length price must sufficiently include the risks taken, and that the most appropriate method depends on the facts and circumstances of each particular case.

The Court observed that the Indian tax authorities had accepted the arm's-length price established by MSAS by applying the transactional net margin method (TNMM). The Court also independently approved the cost-plus margin, finding it appropriate in the case of a service PE. The Court held that as the TNMM method apportions the total operating profit arising from the transaction on the basis of sales, costs, assets, and so on, regarding the attribution of profits to the PE it would be the correct method to arrive at a suitable arm's-length price that must be paid by MS & Co. to its PE. The Court found that a markup of 29 percent charged by MSAS (based on a transfer pricing study using the TNMM method) was correct, and also had been accepted by the Indian tax authorities.

Conclusion

The judgment is a positive addition to the plethora of international tax decisions pronounced by the Indian courts over the past few years. It clearly recognizes that the mere presence of a fixed place of business is not enough; it is important to examine whose business is being carried out through such a fixed place. The question really is whether the business being carried out is of the resident enterprise or of the nonresident enterprise (which alone may constitute a PE under article 5(1)).

This should bring significant respite to the Indian outsourcing industry, which has been bogged down by the Indian tax authorities' unrelenting stance that outsourcing is really the conducting of the activities of the nonresident enterprise itself. The Supreme Court has reiterated the principle that the fact that two enterprises are related should not, in itself, lead to an inference that a PE exists. The Court also observed that the definition of a PE under article 5 of the treaty is exhaustive in nature.

The Court has brought out the fine distinction in the tax treatment of stewardship and deputation. It seems the main difference is the degree of control exercised by the employer. This aspect of intercompany assignments is expected to be closely examined in the future as multinational enterprises will have to structure such transfers of human resources among group entities with careful consideration to avoid a service PE exposure in India. The impact of the transnational migration of employees in the context of secondment will also have to be examined in this context.

The Court also has endorsed the single-entity approach toward the attribution of profits to a PE. This should make its judgment in *Morgan Stanley* a first in international tax jurisprudence across the world. The judgment should also dilute the effect of a recent ruling by the Income Tax Appellate Tribunal (ITAT) in Mumbai in the case of *SET Satellite (Singapore) Pte. Ltd.* (for prior coverage, see *Doc 2007-10928* or *2007 WTD 87-1*). In that case, The ITAT held that the payment of an arm's-length price to a dependent agent does not extinguish the tax liability of a foreign company in India. The ITAT had endorsed the dual-entity approach and held that a dependent agent PE is distinct from the dependent agent and that both can be taxed separately in India. In reaching that conclusion, the ITAT relied on a recent OECD report on the attribution of profits to a PE and an Australian Tax Office paper on the attribution of profits in the case of a dependent agent PE. With the *Morgan Stanley* judgment, the Supreme Court has clearly accepted the single-entity approach thus far followed in India. The Supreme Court's broad acceptance of the principle that once transfer pricing adequately takes into account functions and risks, no further profits are attributable is a positive step.

Interestingly, the Supreme Court has unequivocally indicated the importance of the principle of economic nexus in determining profits attributable to a nonresident enterprise through its PE in India. This follows a string of recent international tax decisions by the Supreme Court that have constantly reiterated and emphasized the need for a clear economic nexus in order for any profits of a nonresident to be taxable in India. In the case of *M/s Hyundai Heavy Industries Co Ltd.*, the Supreme Court held that payments made toward offshore supplies provided by the nonresident could not be attributable to the PE in the absence of economic nexus of such payments with the PE in India. (For that judgment, see *Doc 2007-13761* or *2007 WTD 112-8*.)

The *Hyundai* judgment was preceded by the Supreme Court decision in the *Ishikawajma Harima Heavy Industries Ltd. v. DIT,*[4] wherein it was held

[4]Appeal (civil) 9 of 2007 (SC).

that the concept of territorial nexus was fundamental in determining the taxability of any income in India, and that income from the offshore supply of equipment and services by a foreign company outside India would not be taxable in India merely because the equipment was supplied in relation to a turnkey project in India.

Although the AAR did not rule on the questions relating to transfer pricing, the Supreme Court pronounced on the appropriateness of both the method and the markup arrived at by MSAS in the *Morgan Stanley* case.

Mechanisms such as advance pricing agreements do not exist in India, and it seems the AAR should now be able to rule on questions pertaining to transfer pricing,[5] thus providing certainty to multinational enterprises seeking to do business in India. ◆

♦ *Jitender Tanikella and Bijal Ajinkya, Nishith Desai Associates. Nishith Desai Associates acted as counsel to Morgan Stanley & Co. U.S. However, the views expressed are of the individual authors.*

[5]With the exception of the valuation of assets which is specifically barred for the AAR under the ITA.

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