SBC Tax Alert

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Indian entity is liable to pay service tax on secondments from its overseas group entities rules Supreme Court of India – Its impact under Income-taxes and way forward

In this Tax Alert, we have summarised the recent ruling of the **Supreme Court in the case of *CC, CE & ST Vs. Northern Operating Systems Private Limited [2022-VIL-31-SC-ST]*** wherein the question before the Supreme Court was whether Service Tax is applicable on the cost-to-cost reimbursement of salary and related costs of seconded employees made by an Indian entity to its foreign group entity.

Supreme Court ruled that the Indian entity received manpower supply services from its foreign group entity via secondment of its employees and therefore the Indian entity is liable to pay Service Tax thereon under the reverse charge mechanism.

Important facts of the case and Supreme Court observations are summarised below along with SBC comments on various checkpoints to be borne in mind from GST, Income Tax, and Transfer Pricing perspectives with respect to such secondment arrangements which are very common in Multinational Enterprises (MNEs) operational matrix.

Brief of the case

- Indian entity entered into service agreements with its overseas group entities located in various countries for rendering general back-office and operational support services.
- For providing these services, the Indian entity has entered into secondment agreements with an overseas group entity, wherein the overseas entity was required to second its managerial and technical personnel to India as per the Indian entity's requests. The seconded employees were selected by overseas group entity.
- During the secondment period, the seconded employees were required to act under the directions and control of the Indian entity.
- Salary, bonus/incentives, social security, and welfare benefits of the seconded employees were paid to employees by the overseas entity as they continued to be on their payroll for the purpose of continuation of social security, retirement, and health benefits.
- Such expenses were subsequently reimbursed by the Indian entity to its overseas entity on actuals (cost-to-cost with no markup).
- Revenue has alleged that the overseas group entity is providing 'manpower recruitment and supply agency services' to the Indian entity and sought to levy Service Tax on the reimbursements.

Crux of the issue

If the Indian entity is treated as an employer, the payment would in effect be a pure reimbursement and not chargeable to tax. However, if the overseas entity is treated as the employer, the arrangement would be treated as a 'manpower supply service' and be taxed.

Earlier CESTAT (Tribunal) has held that Service Tax is not payable. Supreme Court reversed the Tribunal ruling and ruled that Service Tax is payable based on the following observations by emphasizing the 'substance over form' principle:

Supreme Court Ruling

- With the passage of time, the primacy of the 'direction and control test' to determine whether a person is an employee or not has diluted. Now, a host of factors need to be weighed together for arriving at conclusion.
- The foreign entity was determining the terms of employment of employees and held to be the 'real employer' of seconded employees. Indian entity exercised operational and functional control over the seconded employees only for the secondment period.
  - Nature of work of foreign entity involved secondment of employees who possessed specialized skills and expertise. Seconded employees possessed specific technical skill which are also evident from the nature of the perks and salary paid.
  - Indian entity could not terminate the employment of seconded employees on cessation of the secondment period and there were to return to the foreign entity on completion of secondment and re-secondment thereof, as per the letter of understanding issued to the seconded employees.
  - Seconded employees continued to be on the foreign entity's payroll and salary to employees was fixed in foreign currency.
- Previous favourable rulings of the CESTAT would not be applicable as the same were not passed with independent reasoning and thus, had no precedential value.
- Accordingly, the Supreme Court ruled that the overseas group entity can be said to have provided manpower supply service and the Indian entity was the service recipient.

SBC comments

As secondment of employees is a common practice among various MNEs wherein there was a settled position at various Tribunals (a plethora of judgements) that the said secondment is not a manpower supply and is mere reimbursement.

This ruling has reversed the said settled position wherein the existing litigations pending at various forums may be decided against the taxpayers.

It is relevant to note that the said ruling did not appreciate the concept or fact of the dual employment structure prevailing in such arrangements.

Way forward

- ***Service Tax standpoint***
  - Already settled litigations cannot be re-opened by imposing the extended period of limitation.
  - Pending litigations likely to be ruled against the taxpayers.
  - Where the service tax audits are pending/not concluded (if any), the said issue may be raised by the authorities and the taxpayers may be asked to discharge the tax liability.

- ***GST standpoint***
  - This ruling shall have an impact on GST liability of the taxpayers wherein the MNEs may have to re-visit the agreements entered with the group companies for the secondment of employees.
  - As the audits by the GST authorities are still open, the said issue may be raised and the taxpayers may be asked to discharge the tax liability under RCM on the said arrangements.

Checkpoints from Income Tax (Permanent Establishment & Withholding Taxes/TDS) and Transfer Pricing standpoint

INCOME TAX

- ***Permanent Establishment (PE) exposure of overseas group entity in India***

The overseas employer runs a risk of triggering PE exposure in the host country depending on the period of presence, nature of work performed, and the text of the contract with the host country which could lead to unwarranted tax and compliance issues. Accordingly, the reimbursement would be the business income of the overseas group entity received on account of services rendered through the employees, liable to tax in India. Further, where the type of services rendered by the seconded employees may also be tested for taxation as Fee for technical/included services.

The overseas employer is considered to have a PE in India if prima facie the following indicative conditions are met:

- If the overseas group entity had seconded its employees to manage the affairs of the Indian entity and to provide technical knowledge.
- The employees for all practical purposes remained employees of the overseas group entity, even though they were stationed at Indian entity's premises.
- The employees continued to make social security contributions in the home country and their salaries were distributed to their personal bank accounts in their home country.
- There is no agreement between the Indian entity and the employees.
- Additionally, under many DTAAs, a service PE exposure may be triggered even by the presence of foreign expat employees one day presence considering the Overseas entity and the Indian entities are associated enterprises.

In view of the above, while drafting an intercompany agreement and deciding terms of deputation between Group companies, the following points should be taken into consideration which may help in mitigating the risk of the overseas entity becoming a PE in India:

- Salaries, allowances, perquisites and benefits payable, and other terms and conditions of employment of the secondment employees with Indian entity would be governed by the Employment Agreement entered into between the Indian entity and the employees.
- The Indian entity will be under an obligation to bear all the salary, perquisites, and other benefits payable to the employees for the assignment. However, the overseas entity may facilitate the disbursement of such salary, on behalf of the Indian entity to the bank account of the employees in their home country solely for the purposes of administrative convenience.
- Indian entity may at its discretion extend or terminate the Employment Agreement entered into with the employees. During the period of assignment, employees shall work solely under the control, direction, and supervision of Indian entity and shall report to the management of the Indian entity. Further, the employees shall be bound by and treated in accordance with the applicable rules and regulations established by the Indian entity.
- The overseas entity shall not be responsible for the selection/ identification of the employees to be sent on assignment to the Indian entity and the overseas entity will only act as per the written instructions/ consent/ communication received from the Indian entity from time to time.
- The overseas entity shall not be responsible to the Indian entity or any other entity for the work executed by the employees during the period of assignment and all the risks and rewards of the work performed by him shall rest with the Indian entity.

- It may be further documented that the employees continue to be on the payroll of the Overseas entity in addition to the Indian entity's payroll for the legal requirements

The above documentation may be equally relevant from the GST standpoint as well.

- ***Withholding Tax/TDS implications***

Withholding Tax/TDS implications depend on the nature of pay-out transactions by an Indian entity to the overseas foreign entity. There may not be any withholding taxes on reimbursements on actuals (cost-to-cost). However, if a service element is involved, appropriate withholding tax implications as per DTAA & Income Tax provisions are to be evaluated while making any pay-outs.

Separately, pursuant to the Supreme Court ruling in the case of *CIT v. Eli Lilly and Co. (India) P. Ltd (312 ITR 225)* it is clear that tax has to be deducted from salaries of expats/seconded employees working in India even in cases where salaries were paid abroad by the foreign entity as the services are rendered in India. It may be obligation of the Indian entity to withhold taxes on the salary paid to expats [i.e., where no work was found to have been performed for no work was found to have been performed for M/s Eli Lilly Inc Netherlands then such payment would certainly come under Section 192 (1) read with Section 9(1)(ii) the Overseas entity]. The two basic principles of source (acts done in India) and residence (presence in India) would therefore be required to analysed by the Indian entities to determine the withholding tax obligations. However, where the Overseas entity undertakes the withholding of taxes, the Indian entity may not be additionally required to withhold taxes

TRANSFER PRICING

Transfer Pricing compliances and analysis will differ based on whether the subject transaction is a pure cost-to-cost reimbursement of salary & related expenses or receipt of manpower supply services requiring a pay-out along with an arm's length markup.

- If it is construed as a service transaction, the determination of an appropriate markup would depend on the nature of service, skill set of the seconded employees, and their reporting & responsibility matrix.
- It is pertinent to note the principle laid by the Supreme Court ruling in the case of *DIT (Int taxation) v Morgan Stanley and Co. Inc. [(2007)292 ITR 416 (SC)* wherein the Court held that if Indian entity/PE are appropriately remunerated then there would not be any further attribution of profits of foreign entity in India as long as the arm's length analysis is exhaustive of functions, assets and risks.
- For making appropriate disclosures in Form No. 3CEB and undertaking correct benchmarking analysis in TP Study, a consistent stand has to be taken for GST, Income Tax (Withholding/TDS) and Transfer Pricing purposes.

Suggested actions

To sum up, this judgment necessitates the following points of analysis for secondment arrangements between overseas group entities and their Indian counterparts:

- Maintaining necessary documentation and identifying the purpose of secondment keeping in mind this Apex Court ruling (law of land).
- Nature of transaction if determined to be in line with the current SC Ruling, a similar stand under Indian-Income tax laws to be taken.
- Foreign companies may now have to collect tax on that portion of salary that was being paid abroad on a monthly basis and add it to the tax that was being deducted on salaries paid in India for services rendered here

- The compliances for the overseas entity under Indian Income-tax laws may be paid special attention especially the TP requirements of filing Form 3CEB, maintaining TP documentation, etc.,
- Reviewing inter-company services agreement, secondment agreements, and independent assignment letters between seconded employees and the group entities to identify necessary amendments/ additional documentation in light of this ruling.

To conclude, secondment agreements could primarily result in GST and PE exposures which the MNEs have to do a 360-degree review to take appropriate actions on any exposures in light of the judicial rulings in this regard.

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