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Direct Tax Alert

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Supreme Court rules on the creation of PE on account of outsourcing of activities to an Indian subsidiary

On 24 October 2017, the Supreme Court of India delivered an important decision on the creation of a Permanent Establishment (PE) in India on account of various services being outsourced to an Indian group company by the taxpayers (e-Funds Corporation and e-Funds IT Solutions Inc.), who were both US tax residents.

Background

The tax authorities had asserted the existence of a fixed place PE, service PE as well as an agency PE. However, the assertions regarding the existence of an agency PE were not pressed by the tax authorities in the course of appellate proceedings. The Income-tax Appellate Tribunal (Tribunal) upheld the contentions of the tax authorities and concluded that a fixed place PE and a service PE existed. On further appeal, the Delhi High Court set aside the findings of the Tribunal and the tax authorities in their entirety. This decision of the Delhi High Court was appealed by the tax authorities at the Supreme Court.

The key factors relied upon by the tax authorities in asserting the existence of a fixed place PE and service PE in India are listed below:

a) The non-resident taxpayers had entered into contracts with their customers for rendering ATM management services, electronic payment management, decision support and risk management and global outsourcing and professional services, which were thereafter assigned/sub-contracted to the Indian group company;

b) The Indian group company relied on proprietary databases and software of the non-resident taxpayers for rendering such services;

c) The services agreement gave the non-resident taxpayers significant control over the employees of the Indian group company;

d) The Form 10K filed with the Securities and Exchange Commission (SEC) in the US showed that a very large percentage of the total group employees are based in India.

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e) In the course of Mutual Agreement Procedure (MAP) proceedings for earlier years, the existence of a PE and attribution of profits thereto were admitted, and that such admission would bind the taxpayers in subsequent years as well.

Supreme Court's findings

On the existence of a Fixed Place PE

Relying on its decision in the case of *Formula One World Championship Limited* v. *CIT* [2017] 394 ITR 80 (SC), the Supreme Court noted that in order to create a fixed place PE, there must exist a fixed place of business in India at the disposal of the non-resident taxpayers, through which they carry on their own business. The Court noted that in this case, there was no specific finding in the assessment and appellate orders, that any fixed place of business had been put at the disposal of the non-resident taxpayers. It held that the tax authorities and the Tribunal had adopted a fundamentally erroneous approach in saying that the contracting arrangement and the outsourcing of activities resulted in the creation of a fixed place PE.

The Court observed that the Indian group company only rendered support services to the taxpayers, which in turn enabled them to render services to their clients abroad. This outsourcing of work to Indian group company would not give rise to a fixed place PE in India.

The Supreme Court also noted that reliance placed on the Form 10K filed with the SEC was misplaced since it was evident that the report dealt with the activities and financials of the worldwide group.

On the existence of a Service PE

The Court noted that under Article 5(2)(l) of the India-US treaty, services must have been furnished '*within India*' through employees or other personnel in order to constitute a service PE. Since none of the customers of the non-resident taxpayers were located in India, or had received any services in India, this requirement was clearly not satisfied.

The Court therefore felt that there was no need for it to examine the issue of whether the words 'other personnel' used in Article 5(2)(l) would cover employees of the Indian company, and whether the non-resident taxpayers were furnishing services in India through such personnel.

On the existence of an Agency PE

Although the tax authorities had not pressed the issue of existence of agency PE, for the sake of completeness, the Court noted that it had never been the case of the tax authorities that the Indian group company was authorized to or exercised any authority to conclude contracts. Hence, it agreed with the finding of the High Court that the taxpayers did not have an agency PE in India.

The Court also noted that following the conclusion in *DIT* v. *Morgan Stanley & Co.* [2007] 292 ITR 416 (SC), as the Indian entity was compensated at arm's length price, no further profits could be attributable even if a PE of the non-resident taxpayers was found to exist in India.

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On the relevance of the MAP settlement for earlier years

Correspondence in relation to the MAP settlement entered into between the competent authorities of India and US indicated that the US authorities did not agree that on technical merits, the taxpayers had a PE in India, and that the settlement was entered into only with a view to avoid double taxation. It was also expressly stated that the determination of the competent authorities would not be binding for subsequent years.

Based on this, the Supreme Court agreed with the taxpayers' contention that the MAP settlement could not be considered as a precedent for subsequent years.

Our Comments

This is the second judgment rendered by the Supreme Court on the scope of a PE in recent months (the other one being the decision in the *Formula One* case).

Although the decision in the Formula One case was far-reaching in many ways, it was nonetheless given in the context of certain specific facts. The judgment in *e-Funds*, however deals with a fact pattern that is widespread in an Indian context. Hence, the principles applied here could have far greater practical impact.

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