Tax Hotline

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RECENT ADVANCE RULING - A SHOT IN THE ARM FOR THE INDIAN OUTSOURCING INDUSTRY

The Authority for Advance Rulings ("**AAR**") has pronounced a landmark judgement in the case of Morgan Stanley & Co, a US investment bank ("**Morgan Stanley**") in the business of providing financial advisory services, corporate lending and securities underwriting services. Like many other multinationals, Morgan Stanley outsources a wide range of high-end support services to its captive group company, Morgan Stanley Advantage Services Private Limited ("**MSAS**"). The ruling is a shot in the arm for the outsourcing industry as a whole and has tremendous implications especially for the emerging KPOs, and for outsourced R&D and contract manufacturing.

One of the daunting questions which the outsourcing industry has been confronted with, is whether outsourcing to Indian companies, particularly to captive service providers / manufacturers would cause a permanent establishment ("**PE**") to come into existence. If Indian tax authorities were to hold that such activities would tantamount to a PE, the global profits attributable to the PE would be taxable in India at the rate of approximately 41% in the hands of the foreign entity. Further, the availability of tax credit for such tax paid in the home jurisdiction may be uncertain, thus potentially leading to double taxation and wiping out the economic advantage of outsourcing to India. On the other hand, if there exists no PE, no profits can be subjected to Indian corporate tax.

In the instant case, Morgan Stanley raised certain questions before the Authority with respect to its outsourcing arrangement, viz.; -

- Whether the Applicant had a PE in India under the India US tax treaty by virtue of MSAS being regarded as (i) its fixed place of business or (ii) a dependent agent or (iii) constituting a service PE on account of deputation of its employees in India?
- Whether the method used for transfer pricing between the Applicant and MSAS was the 'most appropriate' method, and whether the price paid was at 'arm's length'?
- Whether, in case it were to be held that there was indeed a PE in India, there would be anything further attributable to the PE if the PE was compensated at arm's length?

The AAR in the case of Morgan Stanley has held that the captive service provider i.e., MSAS is not a fixed place of business PE of Morgan Stanley, as it is not the business of Morgan Stanley that is carried out from there. The Authority has also held that MSAS would not constitute an agency PE of Morgan Stanley, one of the factors for this being that it does not have the authority to conclude contracts on behalf of Morgan Stanley.

Importantly, on an equally sensitive issue of whether if a PE was constituted, a portion of global profits of Morgan Stanley would be brought to tax in India where the Indian company was compensated at arm's length, the Authority has held in the negative. Given that multinationals doing business with an associated company in India are required to comply with transfer pricing, and to compensate the Indian entity at arm's length, this finding provides much needed certainty regarding exposure to tax in India.

With regard to the exposure to service PE upon the proposed deputation of personnel, the Authority has held that the presence of employees for over 90 days would constitute a service PE in India. The Authority has rejected the contention that as the deputed personnel are sent to MSAS to oversee the functioning of MSAS and to perform quality control and risk management services, they cannot be said to be the employees of the Applicant even though their salaries were borne by the Applicant.

The Authority did not admit the questions relating to transfer pricing on the grounds that the Authority is precluded from giving a ruling on a question which involves determination of fair market value of property. As this question involved valuation of service as well as property in the form of hardware on which the 'deliverables' of service were transmitted, it was rejected. The Authority also denied the ruling on the grounds that the question was already pending, by taking a very stringent view that as in case of taxpayers having international transactions above Indian Rupees 50 million, the tax officers have been instructed to scrutinize the cases without any discretion, it can be said that the question is already pending before the tax authorities and hence, no ruling can be granted on the same. This seems to open a window of opportunity for the admission of questions on transfer pricing when they involve services alone and in cases where a ruling is sought on proposed transaction, where no tax returns are filed.

All things considered, the outsourcing industry in India can rest easy in the knowledge that outsourcing in itself does not expose the business income of multinationals to corporate tax in India. Though in India, an advance ruling is binding only on the Applicant it has significant persuasive value and plays a critical role in the evolution of international tax jurisprudence.

- **Annapoorna Jayaseelan** & **Bijal Ajinkya**

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