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India: M&A Practice – Analysis of Supreme Court's Judgment in E-Funds Vs. DIT Case

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Introduction

The Supreme Court recently issued an important judgment in the case of ***E-Funds IT Solutions vs DIT***[1], providing its detailed analysis on the much-debated topic of when a foreign enterprise's permanent establishment ('PE') is said to exist in India. While rendering this judgment, the court relied in its earlier landmark judgment in the *Morgan Stanley* case[2].

Background

e-Funds Corporation, USA, and e-Funds IT Solutions Group Inc. (together referred to as 'e-Funds US') are companies incorporated and resident in United States of America (USA). e-Fund Corp is the holding company of IDLX Corporation (a company incorporated in USA) which holds 100% shares of IDLX International BV (a company incorporated in Netherlands). IDLX International BV is in turn the holding company of IDLX Holding BV (incorporated in Netherlands) which holds almost 100% shareholding of e-Funds International India Private Limited ('e-Fund India'), incorporated and resident of India.

e-Funds US was involved in the business of ATM Management Services, Electronic Payment Management (providing payment processing software and electronic payment processing services), Decision Support & Risk Management (providing risk management-based data and other products to financial institutions) and Information Technology ('IT') and business process outsourcing services to complement and support its electronic payments business. Various services were sub-contracted by e-Funds US to E-Funds India for execution and the services

provided by e-Funds India enabled e-Funds US to provide these services to its clients in US. All risks for the services rendered to clients were finally borne by e-Funds US. The arrangement between e-Funds US and e-Funds India were on arms-length basis approved by the Indian tax authorities.

The Indian tax authority contended that the income of e-Funds US was attributable to India because they had PE in India and should be taxed in India. The grounds were (a) most of the employees of e-Funds group are based in India, (b) e-Funds US has call centres and software development centres only in India, (c) e-Funds US carried out all marketing activity and the contracts with clients were assigned or sub-contracted to eFunds India (which is indirectly claiming that the marketing activities were being carried out on behalf of e-Funds India), (d) the agreement between the e-Funds US and e-Funds India gives complete control to the e-Funds US with respect to personnel employed by e-Funds India, (e) e-Funds India used the proprietary database and software of eFunds US to provide the services, and (f) the corporate office of e-Funds India houses an international division comprising the president's office and a sales team servicing e-Funds US and its group entities in the United Kingdom, South East Asia, Australia and Venezuela.

Essentially the Indian tax authority claimed taxation of e-Fund's income in India on the basis of existence of fixed place PE, service PE and agency PE in India arising due to the above-mentioned arrangements. The Indian tax authority also referred to Mutual Agreement Procedure ('MAP') between Indian and US tax authority for e-Funds US and e-Funds India for assessment years 2003-04 and 2004-05 per which certain portion of e-Funds US income was agreed to be taxed in India. The Indian tax authority contended that, since the same position and business arrangement continued to exist between e-Funds India and e-Funds US, the earlier MAP order should set the precedent for income of e-Funds US being assessable to tax in India.

The Commissioner of Income Tax (Appeals) and the Income Tax Appellate Tribunal ("ITAT") had upheld the order of the Income Tax Assessing Officer ("AO"), while the Delhi High Court had set aside these orders and held that e-Funds India did not constitute fixed place or service PE of e-Funds US and the MAP related orders of earlier assessment years were immaterial to deciding if PE currently existed. Aggrieved by the order of the Delhi High Court, the Indian tax authority appealed before the Supreme Court.

The issues involved and analysed by the Supreme Court can be summarized as follows:

- Whether E-Funds India constitutes a fixed place PE of e-Funds US in India?
- Whether employees seconded by E-Funds US to e-Funds India constitutes a a service PE of e-Funds US in India?
- Whether E-Funds India constitutes an agency PE of e-Funds US in India?
- Whether the admissions during the MAP for certain earlier assessment years results in admission of existence of PE under current circumstances and result in assessing income of e-Funds US to tax in India?

Supreme Court's Finding

The Court, while rejecting Indian tax authority's claims made the following observations on the above issues:

(i)On Existence of Fixed place PE

The Supreme Court relied on the principles laid out in its earlier judgment in *Formula One World Championship Ltd. Vs. CIT*[3], on what constituted fixed place PE noting that 'in order to ascertain whether an establishment has a fixed place of business or not, is that such physically located premises have to be at the disposal of the enterprise. It is not necessary that the premises are owned or even rented but will be sufficient if the premises are put at the disposal of the enterprise. However, merely giving access to such a place to the enterprise for the purposes of the project would not suffice'.

The Supreme Court noted that there was no specific finding in the orders of the Indian tax authorities to indicate that the premises of Indian company were at the disposal of the US companies, in order to satisfy this test.

The Supreme Court upheld the finding of the Delhi High Court that the Indian tax authorities have erroneously relied upon the close association between e-Funds India and e-Funds US and erroneously applied the functions performed, assets used, and risk assumed criteria to determine existence of fixed place PE. The dependence of e-Funds India on e-Funds US for its earnings and not assuming any risk for services rendered are not the relevant test to determine whether fixed place PE exists.

However, the Supreme Court did agree with its earlier observation in the Morgan Stanley judgment that if a PE has been remunerated on an arms-length basis after taking into account all the risk-taking functions, then no further income would be attributable to PE in India, while if the transfer pricing analysis does not adequately reflect the functions performed and the risks assumed, then there would be a need to attribute profits to the PE for those functions/risks that have not been considered.

(ii)On Existence of Service PE

In deciding on existence of Service PE, the Supreme Court looked at the earlier decision of the Supreme Court in the Morgan Stanley case that Service PE would apply to cases where the foreign company furnishes services within India and through its employees. But mere stewardship services, such as briefing staff of Indian company to ensure quality adherence or such facilitation, would not be sufficient to constitute service PE.

In this case, the Indian tax authorities had claimed existence of service PE on the basis of two employees of e-Funds US seconded to e-Funds India to provide services. The Supreme Court noted that, while the presence of employees in India is relevant to understand if service PE existed, the Indian tax authority had not sufficiently

ascertained whether these seconded employees were performing stewardship services or were directly involved with the working operations of e-Funds India.

The Supreme Court also correlated the importance of Article 42.31 of the OECD Commentary per which if any customer is rendered a service in India, irrespective of such customer being resident in India or outside India, a service PE could be established in India. However, in this case since no service is rendered in India, but instead only auxiliary operations that facilitate such services are carried out in India, there can be no question of a service PE existing in India. Hence, there was no further need to deliberate on where the seconded employees were employed by the Indian company or US company and impact of the same.

(iii)Existence of Agency PE

In this respect, the Supreme Court went the distance in briefly touching upon the agency PE issue despite arguments on it not being tendered during earlier stage. The court noted that the Indian tax authorities have not made a case that e-Funds India was authorized to or exercised any authority to conclude contracts on behalf of the e-Funds US, nor was any factual foundation laid to attract any of the circumstances mentioned under Article 5(4) of the DTAA to constitute agency PE and hence there was no need to deliberate further on this.

(iv)Relevance of Agreement under earlier MAP to determine PE currently

Article 27 of the India-US DTAA pertaining to MAP, requires that the competent authorities of the contracting States should endeavour to resolve by mutual agreement any difficulties or doubts arising on interpretation or application of the convention in order to eliminate double taxation. The Supreme Court, relying on the OECD Model Tax Convention and the OECD Transfer Pricing Guidelines from which the MAP is drawn, noted that it requires both the competent authorities engage in discussion with each other in a principled, fair, and objective manner, with each case being decided on its own merits. Being so, previous agreement cannot be considered as a precedent for subsequent years and hence, the earlier agreement reached between competent authorities of India and US through MAP should hold no relevance to determining existence of PE under current circumstances.

Analysis

This judgment rings in a second round of clarity after the decade old Morgan Stanley case providing much required analysis on tricky issues such as fixed place PE and service PE. Article 5(2)(l) of India-US DTAA mentions that service PE would exist in India if the services were rendered 'in India' by employees or personnel of a US enterprise if the activities of that nature continue beyond 90 days within any twelve-month period or if the services are performed for a related enterprise. However, the Supreme Court relying on the earlier Morgan Stanley judgment has clarified that the seconded employees merely providing 'stewardship' services would not constitute service PE but instead it should be services related to that being provided by the Indian enterprise to the foreign enterprise. More importantly, the Supreme Court has challenged the notion of what constitutes rendering service in India and noting

that auxiliary services being provided by Indian enterprise would not constitute services being provided in India under the definition of Article 5(2)(l) of India-US DTAA. The Supreme Court has also taken a strict interpretation that only a place being at the disposal of a foreign enterprise would determine fixed place PE and mere close association and service arrangement by itself does not have a bearing.

Impact on IT/ITES Industry

While these are welcome observations from the Supreme Court in laying a clear test on this subject matter and providing greater perspective, it could also pave way for a very liberal interpretation of the DTAA resulting in tax leakage. Many foreign companies which have an offshore centre in India could be beneficially impacted by this considering that most of them are merely performing auxiliary services and usually have an arm's length arrangement based on detailed transfer pricing analysis. This also provides a greater opportunity to second employees more often to India with less worry given the emphasis that 'stewardship' services would not constitute 'services in India' for establishing service PE. Hence this judgment could quell the constant unrest in the industry on when the taxman cometh.

Impact on Foreign Funds

Foreign funds have constantly been battling against the potential 'business connection' in India by having advisors in India. Each country presents a unique challenge and much like any other industry, the funds industry finds it indispensable to have advise from local talent in making its investment decision. While safe harbour rules were introduced through section 9A of Income Tax Act, 1961, against fund managers constituting business connection in India of foreign funds, they impose certain strict criteria which may not always be feasible. This judgment could provide additional weight against the PE argument by clarifying the test for fixed place and service PE. Unfortunately, this judgment did not delve much into the test for agency PE under which there is highest propensity for foreign funds having business connection in India.

Conclusion

While India is growing at a tremendous pace and back-end operations constitutes majority of the service being provided by IT/ITES companies and more services being outsourced to India than ever before, any overly conservative or narrow interpretation of the DTAA could spell doom to this multi-billion dollar industry and this judgment does provide a much needed shot in the arm.

On the flipside, this judgment could provide potential for liberal interpretation and exploitation. It is logical to expect that most Indian subsidiaries of foreign companies are providing auxiliary services, which however, could be integral to the overall services provided by the organization to its clients. The services by seconded employees could very well play a vital role in quality control of services provided by Indian enterprise to its foreign associated enterprise(s). However, with the Supreme Court's interpretation, most companies could attempt to broadly classify their services to be auxiliary services and use that as a safe harbour against the first part

of service PE test. Pursuantly, they may not even worry about the nature of services provided by its seconded employees.

Any potential abuse could make the tax authorities increasingly belligerent resulting in increased tax litigation, which by nature of the procedure involved, would create unnecessary jitters to the industry.

Hopefully, this judgment would pave the way for well-balanced interpretation and reduced tax litigation on this subject than the other way around.

Footnotes

[1] Order Dated October 24, 2017, in civil appeal 6082 of 2015

[2] DIT (International Taxation) Vs. Morgan Stanley & Co Inc. (2007) 292 ITR 416 (SC)

[3] (2017) SCC Online SC 474

The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.

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