E Funds ruling - A silver lining for contract service providers!

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The Delhi High Court has recently delivered a ruling in the case of e-Funds, in the context of permanent establishment (PE). The ruling comes as a silver lining for contract service providers, where the Indian Revenue tries to allege that contract service providers in India, whether providing IT, ITeS, BPO, contract manufacturing or toll manufacturing services, on a stand alone basis or by themselves, constitute PEs of the foreign principal companies. The High Court, while reversing the ruling of the Delhi Tribunal, has decided the matter in favour of the taxpayer.

Some of the key takeaways from the aforesaid ruling, are discussed below, along with my comments :

1. A subsidiary of a foreign parent, rendering services to a foreign principal under a contract service provider model (cost plus form of remuneration), i.e. under a "principal to principal structure or model", cannot constitute a fixed place of business PE of the foreign principal. This is also in line with OECD's observations in the revised discussion draft on the commentary to Article 5 of the Model Convention (MC), dealing with PEs.
2. Though not enunciated by the High Court as lucidly as one would have loved, the logic behind the above recital is that the business, which a contract service provider carries out, is its own business of providing services to the foreign enterprise, under a "principal to principal basis"; and cannot under any stretch of imagination, be considered to be the business of the foreign enterprise, for the purposes of constituting a PE of the foreign enterprise, whether or not the service provider carries out functions or renders services, which are core to the overall business of the foreign principal, e.g. development of software for a company engaged in the business of selling software solutions.
3. Provision of intangibles free of cost by the foreign principal in favour of the contract service provider, e.g. platform software, technology, etc, with the support of which, the Indian subsidiary company would render services to the foreign principal, would have no consequences whatsoever in the context of PE of the foreign principal. This is again, most obvious; and the High Court has done well to hold accordingly.
4. The Indian subsidiary could not also constitute "service PE" of the foreign principal, as per the relevant provisions of India-US tax treaty. In this context, the High Court held that for the purposes of "service PE", the foreign principal's own employees can only constitute "other personnel", within the meaning of the said clause. This particular dictum is also most obvious, but has often been misinterpreted by several constituents. In order to constitute

"service PE", the foreign company would need to render services in India to a separate legal entity, such that the remuneration receivable therefrom is otherwise capable of being taxed in the hands of the foreign company in India. The reverse scenario, namely where an Indian company renders services to a foreign company against consideration, can never raise any implication of "service PE" of the foreign company in India.

5. The High Court also held that on the facts of the case, the Indian subsidiary, rendering back office functions for the foreign principal, did not constitute a dependent agency PE of the foreign principal, since it did not satisfy any of the conditions of dependent agency PE, as enshrined in the India-US treaty, being more or less similar as other treaties signed by India, namely - (a) concluding contracts; (b) stocking & delivering goods; or (c) securing orders, on behalf of the foreign principal.
6. Having said that, the High Court also ventured to examine the clause of "independent agency", to hold that since the Indian subsidiary had dealt with the foreign principal at arm's length, there was no threat of agency PE, even otherwise. It is submitted that the stroll taken by the High Court in the realms of the clause of "independent agency" was not at all necessary, since the requirement of dealing at arm's length is a condition for exemption, as enshrined in the UN MC & also some of the tax treaties signed by India, to be satisfied if the agent, who otherwise falls within the ambit of "dependent agent PE", having performed any of the functions referred to in paragraph (5) above, renders services virtually to a single principal. If the Indian entity does not constitute a "dependent agency PE" in the first instance, by not having satisfied any of the conditions referred to in paragraph (5) above, then there would not be any reason to examine the arm's length nature of dealings between the Indian entity and the foreign principal, from a PE standpoint.
7. An important point came up for consideration, namely whether some of the senior personnel of the Indian subsidiary were rendering key managerial functions for some of the overseas group entities, so that the premises of the Indian subsidiary could be held to constitute a "place of management" PE of any of such foreign group entities. The High Court did not examine the relevant issue, since there was no such assertion by the lower authorities; and further, there were no facts on record to decide upon such issue during the course of an appeal before the High Court on certain specific substantial questions of law. One would need to examine such issue with care in a situation where senior managerial persons of the MNE group reside in India, vis-a-vis whether or not the premises of the Indian subsidiary company would constitute a "place of management" PE of the foreign parent.
8. The High Court made certain observations with respect to the manner of attribution of profits to PE, which, it is submitted, were not relevant, since the foreign company was anyway held not to constitute any PE in India; and thus,

> the question of attributing profits to any such fictitious or non-existent PE should or could not have arisen. The relevant observations of the High Court need to be read as "obiter dictum".

Thus, for Indian subsidiaries of foreign MNEs, operating in India as contract service providers, under "principal to principal models", the only point for consideration is transfer pricing in the hands of such Indian subsidiaries; and not existence or otherwise of PEs of the foreign principals, in the form of such Indian subsidiaries.

Though the issue did not arise before the High Court, requiring detailed deliberation, it is important to note that if the foreign principal deputes its technicians to work in the premises of the Indian subsidiary (being a contract/ toll manufacturer or contract IT/ ITeS service provider), while remaining under the overall supervision, control & ownership of the foreign principal, for a considerable period of time, say crossing the general threshold limit of creating a fixed place of business PE (i.e. 6 months), then the space in the premises of the Indian subsidiary company, as opposed to the Indian subsidiary company itself, occupied by the employees of the foreign company for carrying out business activities of the foreign company, i.e. ensuring whether the subsidiary company is providing services as per the specifications of the foreign company, might constitute a PE of the foreign company (unless the functions could be argued to be covered by the exemption clause, being in the nature of preparatory & auxiliary), with consequences of profit attribution, most likely under a cost plus model, if the functions performed by the technicians are routine in nature; or in extreme cases, under a profit split model, if the functions performed by such technicians are non-routine or strategic in nature. However, the crux of the matter would still remain that the Indian subsidiary, on a stand alone basis or by itself, would not create a PE of the foreign principal under such circumstances.