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Delhi High Court upholds AAR ruling on secondment agreement giving rise to Service PE and withholding tax obligations

In brief

The Delhi High Court[1] (HC) upheld the ruling of the Authority for Advance Rulings (AAR) in the case of Centrica India Offshore Pvt Ltd[2] on employee secondment giving rise to Permanent Establishment (PE) holding that services rendered by deputed employees “makes available” technical knowledge to the Indian entity and hence payment for those services was taxable as fees for technical services as per the Double Taxation Avoidance Agreement (DTAA). Further, reimbursement of salary and other associated costs by the Indian Company without an element of income could not be construed as diversion of income by overriding title.

Facts

- Centrica India Offshore Pvt. Ltd. (Centrica India or CIOPL) was a subsidiary of Centrica Plc., United Kingdom (Centrica UK). British Gas Trading Ltd. (BSTL), UK and Director Energy Marketing Ltd. (DEML) Canada were also subsidiaries of Centrica UK, both collectively referred to as "overseas entities".
- The overseas entities outsourced some of their back office support functions to third party vendors in India.
- Centrica UK set up Centrica India to act as an interface between the third party vendors in India and the overseas entities.
- Centrica India provided services to Overseas Entities in terms of a Service Agreement under a cost-plus arrangement.

[1] Centrica India Offshore Pvt Ltd *v.* CIT & Ors. [TS-237-HC-2014(DEL)]
[2] Centrica India Offshore Private Ltd *In re* [TS-163-AAR-2012] pronounced on 14.03.2012

- Centrica India, in order to fulfil its role envisaged in the service agreement, had asked the overseas entities to provide staff with knowledge and experience of various processes and practices employed by them.

- A secondment agreement was entered into between Centrica India and the overseas entities under which some managerial employees of the overseas entities were deputed to Centrica India for short term assignments ranging from three to nineteen months.

- Centrica India had entered into individual agreements with the seconded employees which reiterated the terms of the secondment agreement.

- Some key features of the agreement between Centrica India and overseas entities were:

  – The secondees had to function and act exclusively under the direction, control and supervision of Centrica India.

  – Overseas entities were not responsible for the work of the secondees and had no responsibility for their errors/ omissions or for the work performed by them.

  – All the rules, regulations, policies and other practices established by Centrica India for its employees were to apply to the secondees. Centrica India had to bear all risks in respect of work performed by the secondees and had the benefit from their output.

  – The secondees continued to participate in the overseas entities' retirement and social security plans and other benefits in accordance with its applicable policies.

  – The termination clause in the secondment agreement was *qua* the parties to the agreement and was not *qua* the secondees.

- To make sure the salaries were received uninterruptedly and to avoid any delay in payment, at the request of the secondees, the salary was paid directly by the overseas entities into their overseas bank account and claimed as reimbursement from Centrica India. Such salaries were offered to tax in India by the secondees after withholding tax obligations for employee taxes.

The AAR ruling

- On a reading of the secondment agreement, the right of the seconded employees to seek their remuneration was only against the overseas entities and not against Centrica India.

- The right of termination of services of seconded employees vested in, or rested with the overseas entities, even though control and supervision over them was with Centrica India.

- The terms of the contract had to be understood on their reading, and mere nomenclature could not be determinative of the relationship brought about between or among the parties.

- The work performed by the secondees in India was not unconnected with the activities of the overseas entities in coordinating the work of their third party vendors in India. Furthermore, it was therefore a case where some employees qualified in the processes and procedures of the overseas entities were lent to Centrica India to perform the functions envisaged for it.

- The obligation to pay salary was different from the obligation to compensate the employer for what is paid by him to the employee; the latter obligation could not amount to reimbursement of salary. This position remained unaltered irrespective of accounting treatment in the books of Centrica India or the overseas entities.

- It was not a case of diversion of income by overriding title since, at the point of time when Centrica India paid to the overseas entities, the event of salary payment had already taken place and the secondees had no title over the amount made over by Centrica India.

- Payments by Centrica India were compensation for managerial services covered by section 9(1)(vii) of the Income-tax Act, 1961 (the Act). They were not fees for technical/included services under the India-UK/ Canada tax treaty as the secondees were not performing technical or consultancy functions.

- Since the seconded employees were rendering services for the overseas entities by working for a specified period with Centrica India, it would give rise to a service PE in terms of paragraph 2(K) of Article 5 of the India-UK tax treaty and paragraph 2(l) of Article 5 of the India-Canada tax treaty. Hence, it would

be income accruing to the overseas entities; tax was therefore required to be withheld under section 195 of the Act.

Issues before the HC

- Whether the reimbursement of salary costs of secondees by Centrica India to overseas entities under the terms of the secondment agreement was in the nature of income accruing to the overseas entities?
- If so, whether Centrica India was liable to be withhold tax under section 195 of the Act?

Taxpayer's contentions

- The secondment agreement and the individual agreements with the seconded employees established that Centrica India was the real and economic employer.
- Further, effective and overall control vested with Centrica India and the overseas entities were only facilitating payment of salary.
- Mere secondment of employees would not amount to rendition of services through them by the overseas entities.
- The overseas entities had not lent their employees to provide managerial services to Centrica India.
- Also, reimbursements made to such overseas entities were not taxable as income in India because the taxes were already paid in respect of the seconded employees in India.

Revenue's contentions

- The deputed employees were rendering managerial services and as such, the remuneration payable in respect of these deputed employees were in the nature of 'fees for technical services' as per section 9(1)(vii) of the Act.
- Reliance was placed on the decision of the Delhi High Court in the case of Bharti Cellular Ltd[3] to conclude that the services performed by these deputed employees would fall under the definition of 'fees for technical services' as per the Act.
- On review of the secondment agreement, it was clear that seconded employees had to possess technical expertise to support the business services of the overseas entity and to train and familiarize the staff in India with the processes and practices, thereby making available their expertise and skill to the Indian operations.
- It was a case of making available technical knowledge, experience and skill and would be within the purview of Article 12 of the India–Canada tax treaty and Article 13 of the India–UK tax treaty respectively.

HC ruling

Fees for technical services - applicable

- The business support services provided by the deputed employees would clearly fall under the definition of technical services as per Article 12 of the India-Canada DTAA and of included services as per Article 13 of the India-UK DTAA.
- Further, the deputed employees were imparting their technical expertise and know-how to the local employees of Centrica India, thereby transferring and making available their technical ability for future consumption.

Service PE - applicable

- Though the control and supervision rested with Centrica India and they bore all risks in relation to their work; there was no purported relationship between Centrica India and the deputed employees.
- The employees were entitled to participate in the overseas retirement and social security plans and other benefits.

[3] CIT *v.* Bharti Cellular Ltd [2009] 319 ITR 139 (Delhi-HC)

- There was no obligation clearly spelt out that Centrica India has to bear the salary cost of the deputed employees i.e., these employees could not sue Centrica India for any defaults in payment of their salaries.

- No powers were vested with Centrica India to terminate the ultimate contract between the overseas entities and the deputed employees.

- Whilst Centrica India may have had operational control over these persons in terms of their daily work and may have been responsible for their failures (in terms of the agreement), these limited and sparse factors could not displace the larger and established context of employment abroad.

- In the light of the above undisputable facts and reliance placed on the Supreme Court decision in the case of Morgan Stanley[4] and OECD commentary on Article 15 of the Model Convention, there existed a Service PE in India so long as the employees continued to have lien on their jobs with the overseas entities.

- The real employer of the seconded employees continued to be the overseas entity concerned.

Payment is not reimbursement, rather payment for services

- The absence of a mark-up could not negate the nature of the transaction. The nomenclature or lesser-than-expected amount charged for such services could not change the nature of the services.

- The division bench in E-funds[5] highlighted that the nature of activity undertaken by the employee was determinative of whether it constituted a service. The employees deputed to Centrica India were overseeing the quality of the work of the third party vendors in India; such services could not be characterized as mere stewardship.

Payment is not diversion of income by overriding title

- The argument raised by Centrica India that the payments made to the overseas entity were not income that accrued to the overseas entity, rather it was obliged to pass on the same to the secondees, was untenable.

- Such payments were not in the nature of reimbursements but were payment for services rendered through deputed employees.

- The overseas entities were independently obliged under a separate agreement to pay the deputed employees irrespective of the reimbursements from Centrica India.

- The reimbursement made by Centrica India accrued to the overseas entity, which may or may not utilise such reimbursements to discharge its obligation to the deputed employees.

- Accordingly, such reimbursements could not be construed as diversion of income by overriding title.

PwC observations

- Secondment of employees, agreements for secondment and reimbursement, legal and economic employment have been a matter of discussion in various judicial forums. The present judgment is likely to cause the tax department to seek taxes for reimbursement of salaries paid by an overseas entity.

- There is more than ever a need to carefully document in "substance" the nature of employment, secondment, rights and duties of all parties to a secondment arrangement.

- Separately implications under Social security law and Service tax need to be considered.

- This ruling is not the end of the road or a settled position since there are various other rulings that can be relied upon by taxpayers.

[4] Morgan Stanley & Co. *In re* [2006] 284 ITR 260 (SC)
[5] DIT *v.* E-Funds IT Solution [TS-63-HC-2014(DEL)]

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Ahmedabad President Plaza, 1st Floor Plot No 36 Opp Muktidham Derasar Thaltej Cross Road, SG Highway Ahmedabad, Gujarat 380054 Phone +91-79 3091 7000	**Bangalore** 6th Floor, Millenia Tower 'D' 1 & 2, Murphy Road, Ulsoor, Bangalore 560 008 Phone +91-80 4079 7000	**Chennai** 8th Floor, Prestige Palladium Bayan 129-140 Greams Road, Chennai 600 006, India Phone +91 44 4228 5000	**Hyderabad** #8-2-293/82/A/113A Road no. 36, Jubilee Hills, Hyderabad 500 034, Andhra Pradesh Phone +91-40 6624 6600	**Kolkata** 56 & 57, Block DN. Ground Floor, A- Wing Sector - V, Salt Lake. Kolkata - 700 091, West Bengal, India Telephone: +91-033 - 2357 9101/4400 1111 Fax: (91) 033 - 2357 2754
Mumbai PwC House, Plot No. 18A, Guru Nanak Road - (Station Road), Bandra (West), Mumbai - 400 050 Phone +91-22 6689 1000	**Gurgaon** Building No. 10, Tower - C 17th & 18th Floor, DLF Cyber City, Gurgaon Haryana -122002 Phone : +91-124 330 6000	**Pune** GF-02, Tower C, Panchshil Tech Park, Don Bosco School Road, Yerwada, Pune - 411 006 Phone +91-20 4100 4444	For more information contact us at, pwctrs.knowledgemanagement@in.pwc.com	