

Tax Hotline

July 09, 2007

SUPREME COURT RULES ON PERMANENT ESTABLISHMENT IN THE OUTSOURCING INDUSTRY

The Supreme Court of India (“**Supreme Court**”) has earlier this morning, pronounced in a landmark judgment that the performance of back-office and other outsourced services, by a captive group company to its parent company should not per se create a permanent establishment (“**PE**”) of the parent company in India . The Supreme Court thus disposed of the special leave petition (“**SLP**”) filed by the revenue authorities against the **ruling** of the Authority for Advance Rulings (“**AAR**”) in matter of Morgan Stanley & Co. U.S. (“**Morgan Stanley**”). However on account of services rendered by personnel of the parent company on deputation to the captive service provider, the Supreme Court held (in the context of the India U.S. Tax Treaty) that it would constitute a PE. Nevertheless the Supreme Court also held that personnel of the parent company engaged in stewardship activities in the captive group company, would not constitute a PE for the parent company in India . Thus multinationals enterprises would have to henceforth structure inter-company assignments for their employees with careful consideration.

Morgan Stanley is in the business of providing financial advisory services, corporate lending and securities underwriting services. As is the case with 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**”). Earlier last year the AAR had ruled upon an application by Morgan Stanley that the activities of MSAS will not constitute a PE of Morgan Stanley in India ; the revenue authorities had filed an SLP against this ruling. The Supreme Court has, in today’s judgment re-affirmed the ruling of the AAR in this regard.

With regard to attribution of profits to the PE, the Supreme Court upheld that the Transactional Net Margin Method (“**TNMM**”) would be the correct method to arrive at a suitable arm’s length price which must be paid by the non-resident enterprise to its PE. The Supreme Court found that the mark-up of 29% being charged by MSAS (based on a transfer pricing study using the TNMM method) was correct and also accepted by the revenue authorities.

The Supreme Court also found that once an arm’s length price has been paid by a non-resident enterprise to its PE in India, nothing further can be attributed. In this regard the Supreme Court noted that the transfer pricing study to determine the arm’s length price will have to properly include the risks taken.

Only the operative part of the judgment has been pronounced in open court and the text of the judgment is to be made public shortly. We will be sending a follow-up hotline after perusing the same.

- Jitender Tanikella & Shefali Goradia

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