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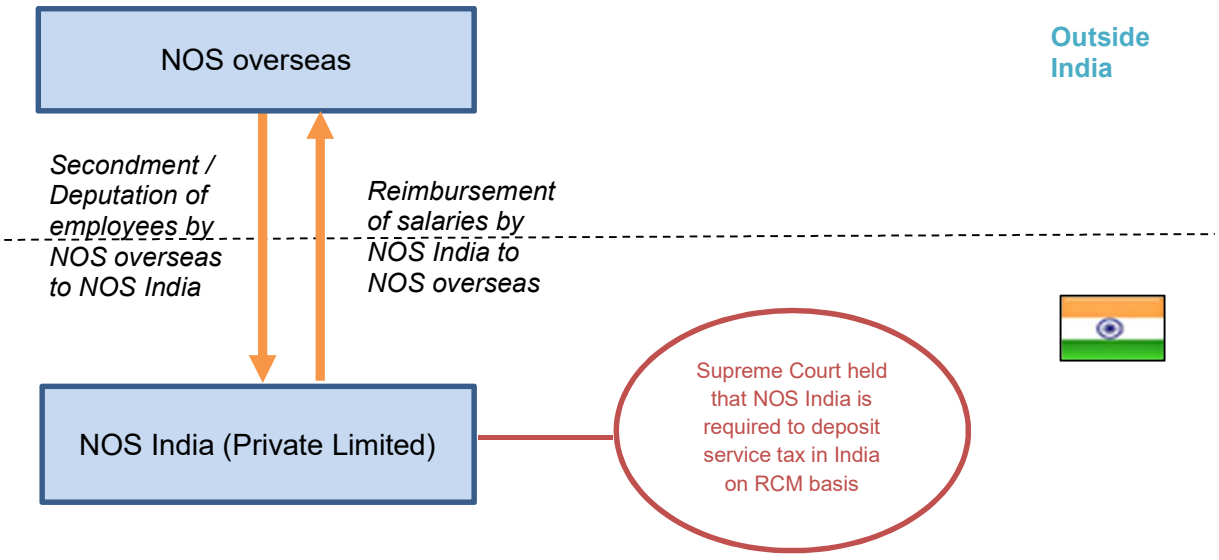
Impact of Supreme Court's decision (in case of Northern Operating Systems) on levy of service tax on secondment / deputation of employees from parent company to Indian subsidiary

Background

On 19 May 2022, the Supreme Court of India delivered a decision which shook the settled belief of multinational companies doing business in India. The decision was delivered in case of a taxpayer called Northern Operating Systems Private Limited (NOS) and related to levy of service tax on secondment / deputation of employees by foreign parent company to the Indian subsidiary (private limited company) wherein salary is disbursed (paid) by the foreign parent company and the same is later reimbursed by the Indian subsidiary on actuals basis to the parent company.

The Supreme Court held that service tax is chargeable on reimbursement of salary by the Indian subsidiary to the foreign parent company and needs to be deposited by the Indian subsidiary with Indian tax authorities on Reverse Charge Mechanism (RCM) basis as consideration for 'manpower supply service'. This decision is against the settled belief of multinational companies doing business in India that such reimbursement is not chargeable to service tax (now Goods & Services Tax or 'GST').

This article explains the Supreme Court's decision on the matter and what could be the possible course of action for subsidiaries of multinational companies operating in India. Many (or most) of the multinational companies in India follow similar policy for deputation / secondment of employees (expatriates) from overseas parent company to India. Hence, it is important to understand the implication of Supreme Court's decision on multinational companies doing business in India.



Facts in case of NOS

- NOS India (Indian subsidiary / taxpayer), entered into agreements with its group companies (NOS overseas) located in USA, UK, Singapore, etc. to provide general back office and operational support to such group companies

- As per the agreement, NOS India requests NOS overseas for managerial and technical personnel to assist in its business when required. The employees are selected by NOS overseas and they would be transferred to NOS India

- The employees shall work at the direction and instructions of NOS India. They would continue to be on payroll of NOS overseas for the purpose of continuation of social security/ retirement benefits. However, for all practical purposes, NOS India shall be the 'employer' during the term of secondment / deputation.

- NOS India issues employment letter to the seconded / deputed employees mentioning the terms and conditions of employment

- The seconded / deputed employees would receive their salary, incentive, etc. from NOS overseas. NOS overseas shall raise a debit note on NOS India to recover the expenses of salary, incentive, etc. and NOS India shall reimburse the same to NOS overseas. There shall be no mark-up or profit on such reimbursement. This is a common arrangement and also helps in mitigating Permanent Establishment (PE) exposure for NOS overseas in India as per the direct tax laws of India.

- The withholding tax obligation on salaries paid to seconded / deputed employees was discharged by NOS India and annual tax deducted at source (TDS) certificate in Form 16 was issued by NOS India to the employees.

Dispute raised by Indian tax authorities

- Tax department issued notice to NOS India for the period October 2006 to September 2014 (i.e., during service tax regime) alleging that NOS India had failed to discharge service tax liability under the category of 'manpower recruitment or supply agency service' with regard to the seconded / deputed employees

- NOS India's position was that Employer-Employee relationship is outside the scope of service tax. The 'real employer' in this case was NOS India (and not NOS overseas). Salaries paid to the seconded / deputed employees cannot be said to be consideration paid to NOS overseas and hence not chargeable to service tax in India

Decision of appellate authority, Customs Excise & Service Tax Appellate Tribunal (CESTAT)

- CESTAT decided the matter in favour of NOS India by relying on previous rulings in case of Computer Sciences Corporation India Private Limited, Volkswagen India Private Limited and Honeywell Technology Solutions Private Limited. Tax department submitted appeal with the Supreme Court

Main issues before the Supreme Court

- Whether deputation / secondment of expatriate employees qualifies as 'manpower supply service' taxable in hands of NOS India under reverse charge mechanism?

- W*ho is the 'real' employer of the seconded / deputed employees in this case – NOS overseas or NOS India.* If the 'real' employer is NOS India, then what is paid to NOS overseas is only a reimbursement and accordingly no service tax is chargeable in India. If, however, the 'real' employer is NOS overseas, then the services provided by NOS overseas to NOS India would be treated as service and hence chargeable to service tax in India

Supreme Court's decision on the matter

The Supreme Court decided the matter against NOS India and held that service tax is chargeable on reverse charge basis on the payment of consideration by NOS India to NOS overseas. While doing do, the Supreme Court made the following observations:

- The Supreme Court referred to the relevant provisions of the service tax law in India, agreements between NOS overseas and NOS India, letter of employment issued by NOC India to the deputed / seconded employees

- There is no single benchmark which can be considered as the sole criteria. The main test is 'substance over form' (at times also referred as 'lifting of corporate veil' in context of corporate governance) requiring a close look at the terms of the contracts / agreements

- The employee, for the duration of secondment / deputation, is under the control of NOS India and works under its direction. *Yet*, the fact remains that the employee is on the pay rolls of NOS overseas. Hence the 'real' or 'effective' employer in this case is NOS overseas (and not NOS India)

- The arrangement in this case is in the nature of 'manpower recruitment or supply agency services' provided by NOS overseas to NOS India

- High weightage was given by the Supreme Court to the fact that *after* the completion of secondment / deputation period, the employees would be repatriated or sent back to the home country. This again indicates that the long term or real or effective owner is NOS overseas and not NOS India

- That NOS overseas is the effective employer, is also proved by the fact that the allowances of the seconded / deputed employees include a separate hardship allowance of 20% on basic salary for working in India. In addition, the monthly housing allowance and an annual utility allowance is also assured. These are substantial amounts and resorts to a standardized policy of NOS overseas which is the effective employer in this case

- The terms of employment, even during secondment / deputation, are in accordance with the global policy of NOS overseas and hence NOS overseas is the real employer

- The orders of CESTAT, affirmed by Supreme Court in Volkswagen and Computer Sciences Corporation cases, are unreasoned and provide no guidance in this case

Accordingly, Supreme Court held that NOS India was the service recipient of NOS overseas. NOS overseas had provided manpower supply to NOS India on which NOS India was liable to deposit service tax on reverse charge mechanism basis in India

Implications of Supreme Court's decision

- The ruling though delivered in context of service tax regime in India, should be applicable on GST also. GST was introduced in India since July 2017. Based on the ruling of Supreme Court, reportedly, India tax authorities have approached some multinational companies asking them to deposit GST in India on similar secondment / deputation contracts. This has created some unrest among multinational companies in India since they have been following the standard industry practice of secondment / deputation of employees (expatriates) from head office to India without paying Service Tax / GST, for a long time

- The position being taken by Indian tax authorities based on Supreme Court's ruling could have an adverse effect on ease of doing business in India for multinational companies. While independence of judiciary is well appreciated and respected, asking multinational companies to deposit GST in India from a retrospective (earlier) date is not a welcome decision and adds to the tax uncertainty in India. Alignment of tax laws and positions with overall objective of the Government is much required in the Indian economy

- The taxable value on which Service Tax / GST should be calculated is also required to be ascertained as to whether Service Tax / GST should be levied on the cross-charge value to the foreign parent entity or entire cost to the company of the seconded employee (including any perquisites, pay-outs, income-tax etc. borne / paid directly by the Indian entity) should also be considered for the purpose of levy of Service Tax / GST.

- Our view – Though legally the action of tax authorities cannot be termed as completely incorrect because it is based on decision of the Supreme Court which constitutes 'law of the land' as per the Constitution of India, in our view multinational companies may like to wait before proceeding to deposit GST in India *suo moto* from their own side. Though it may sound a bit aggressive positon, our view is based mainly on the following reasons:

    - ✓ It is possible that the Indian Government may come out with some kind of clarification in future. In such situation, if the GST will have already been deposited

by the Indian subsidiaries suo moto from their own side, and it is later found / clarified that GST should not have been deposited, then obtaining a refund from tax authorities at that point of time may become a difficult task for the taxpayers.

- ✓ Deposit of GST by Indian subsidiaries suo moto from their own side may have adverse impact from a direct tax perspective. The Indian income-tax authorities may perceive it as constitution of 'PE' in India of the overseas parent company and may accordingly try to tax the overseas parent company in India. Alternatively, even if no PE is constituted in India, the reimbursement to overseas parent company may be viewed as 'fee for technical services' liable to withholding tax @ 10% in India

- Hence, in our view, it is a 'wait and watch' situation. Please note that this is only our personal view on the matter and is not meant to be a professional advise in any manner. The multinational companies in India are free to take an independent action based on their management's decision.

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