24 May 2022

# EY Tax Alert

## SC holds secondment of employees between group companies is a taxable service

Tax Alerts cover significant tax news, developments and changes in legislation that affect Indian businesses. They act as technical summaries to keep you on top of the latest tax issues. For more information, please contact your EY advisor.

## Executive summary

This Tax Alert summarizes a recent ruling[1] of Larger Bench of the Supreme Court (SC). The issue relates to the levy of service tax on secondment of employees by the foreign group company to the Indian entity wherein the salary is disbursed by the foreign company and the same is later reimbursed by the Indian entity at actuals.

SC observed that, while deciding whether an arrangement is a contract "of" service or a contract "for" service, the courts do not give primacy to any single determinative factor. It has consistently applied one test: substance over form, requiring a close look at the terms of the contract or the agreements.

The overall effect of the agreements clearly points to the fact that the foreign company has a pool of highly skilled employees, who are entitled to a certain salary structure as well as social security benefits. These employees, having regard to their expertise and specialization, are seconded (deputed) to the Indian entity for use of their skills.

While the seconded employee, for the duration of secondment, is under the control of the Indian entity and works under its direction, the fact remains that they are on the payrolls of their foreign employer. The secondment is a part of the global policy of the overseas employer loaning their services on a temporary basis. On the cessation of the secondment period, they must be repatriated in accordance with a global policy.

Accordingly, SC held that the Indian entity was the service recipient of the foreign company, which can be said to have provided manpower supply service or a taxable service.

[1] 2022-TIOL-48-SC-ST-LB

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# Background

- The taxpayer entered into agreements with its group companies located in the U.S.A., U.K., Ireland, Singapore, etc. to provide general back office and operational support to such group companies.
- The relevant terms of the agreement are as follows:
  - When required taxpayer requests the group companies for managerial and technical personnel to assist in its business, the employees are selected by the group company and they would be transferred to the taxpayer.
  - The employees shall act in accordance with the instructions and directions of taxpayer. The employees would devote their entire time and work to the employer seconded to.
  - The seconded employees would continue to be on the payroll of the group company (foreign entity) for the purpose of continuation of social security/ retirement benefits, but for all practical purposes, taxpayer shall be the employer during the term of transfer or secondment.
  - Taxpayer issues an employment letter to the seconded personnel stipulating all the terms of the employment.
  - The employees so seconded would receive their salary, bonus, social benefits, out of pocket expenses and other expenses from the group company.
  - The group company shall raise a debit note on taxpayer to recover the expenses of salary, bonus etc. and the taxpayer shall reimburse the group company for all these expenses. There shall be no mark-up on such reimbursement.
- The taxpayer issues prescribed forms to the seconded employees as per the Income Tax Act.
- Revenue issued show cause notices (SCNs) covering the period October 2006 to September 2014 alleging that the taxpayer had failed to discharge service tax under the category of "manpower recruitment or supply agency service" with regard to certain employees who were seconded by the foreign group companies.
- CESTAT relied on previous Tribunal rulings in the case of Honeywell Technology Solutions Pvt Ltd[2], Volkswagen India Pvt Ltd[3] and Computer Sciences Corporation India Pvt Ltd[4].

  It held that those seconded to the taxpayer were working in the capacity of employees and receipt of salaries by group companies was only for disbursement purposes. The employee-employer relationship existed, and the activity could not be termed as "manpower recruitment and supply agency."[5]
- Revenue preferred an appeal before the Supreme Court (SC).

# Revenue's contentions

- Reference was made to the independent letter of agreement between the foreign group company and one of the seconded employees which specifically stated that secondment was a limited duration assignment in terms of which the employee had the right to terminate the engagement.
- The real reason or purpose for the secondment by the overseas companies was to ensure that their expertise was utilized for the performance of tasks by the taxpayer in terms of the service agreement and the master services agreement. Such secondment used their skill sets and expertise to ensure the quality required by the overseas company.
- Upon the cessation of the assignment, the employees reverted to their original position in the overseas companies to work there or deployed elsewhere in terms of the global policy.
- Taxpayer was not enabled to impose sanctions, such as cut in salary, etc. In case it was dissatisfied, it could only ask for return of the employee to his original position with the foreign employer.
- Thus, it is clear that the contract between the parties was essential for the supply of services by the overseas company to the taxpayer.

# Taxpayer's contentions

- Circular F. No. B1/6/2005-TRU dated 27 July 2005 clarified the scope of "Manpower Recruitment or Supply Agency" service to include staff who are not contractually employed by the recipient but come under his direction. This view is further strengthened by Master Circular No. 96/7/2007-ST dated 23 August 2007.

  Post July 2012, the services provided by an employee to the employer in the course of employment are kept beyond the ambit of the definition of "service".

  Thus, the position of law both prior to as well as post July 2012 is same. Employee-employer relationship is outside the scope of the said service.
- The seconded personnel are contractually hired as the taxpayer's employees. Such employees devote all their time and efforts under the direction of the taxpayer. They are required to report to the designated offices and are accountable for their performance to the taxpayer. The process of dispersal of the salaries and allowances is solely for the sake of convenience and continual of the social security benefits in the expats home county.
- In case of Nissin Brake India (P) Ltd[6], SC while considering similar set of facts dismissed the revenue's appeal, which had challenged the CESTAT's ruling that expenses reimbursed by the Indian companies to the foreign group companies in relation to seconded

[2] 2020-TIOL-1277-CESTAT-BANG
[3] 2013-TIOL-1640-CESTAT-MUM – later affirmed by SC
[4] 2014-TIOL-434-CESTAT DEL – later affirmed by SC
[5] 2021-TIOL-06-CESTAT-BANG
[6] 2019-TIOL-151-SC-ST

employees cannot be subject to service tax under Manpower Recruitment or Supply Agency Service.

- The demand of the service tax is being computed on the salaries and allowances paid to the employees. The salaries cannot be said to be consideration paid to group companies for provision of service and thus, such demand is untenable.

  Any cost or expense reimbursed does not represent the gross value of taxable service and cannot be a consideration for charging service tax. Reliance is placed on the SC ruling in case of Intercontinental Consultants and Technocrats Pvt Ltd[7] in this regard.

- Even if the said demand of service tax is paid, the entire amount is available as input credit and is refunded to the taxpayer in cash by virtue of Rule 5 of the CENVAT Credit Rules, 2004 read with Rule 6A of the Service Tax Rules, 1994.

## SC ruling

- SC referred the relevant provisions of Finance Act 1994, service agreement, secondment agreement, master service agreement (all three between the taxpayer and foreign entities) and letter of understanding between seconded employee and taxpayer.
- It observed that the crux of the issue is taxability of the cross charge, which is primarily based on who should be reckoned as an employer of the secondee.

  If the Indian company is treated as an employer, the payment would in effect be reimbursement and not chargeable to tax. However, in the event the overseas entity is treated as the employer, the arrangement would be treated as service and be taxed.
- There is not one single determinative factor, which the courts give primacy to, while deciding whether an arrangement is a contract "of" service or a contract "for" service. SC has consistently applied one test: substance over form, requiring a close look at the terms of the contract or the agreements.
- The seconded employee, for the duration of his or her secondment, is under the control of the taxpayer, and works under its direction. Yet, the fact remains that they are on the pay rolls of their overseas employer. What is left unsaid and perhaps crucial, is that this is a legal requirement, since they are entitled to social security benefits in the country of their origin. It is doubtful whether without the comfort of this assurance, they would agree to the secondment.

  Further, the reality is that the secondment is a part of the global policy of the overseas employer loaning their services, on temporary basis. On the cessation of the secondment period, they have to be repatriated in accordance with a global policy.
- The letter of understanding between the taxpayer and the seconded employee nowhere states that the latter would be treated as the former's employees after the seconded period (which is usually 12-18 months). The salary package, with allowances, etc., are all expressed in foreign currency.
- Further, the allowances include a separate hardship allowance of 20% of the 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 the overseas employer.
- The overall effect of the agreements clearly points to the fact that the overseas company has a pool of highly skilled employees, who are entitled to a certain salary structure as well as social security benefits. These employees, having regard to their expertise and specialization, are seconded (deputed) to the taxpayer for use of their skills.
- Their terms of employment, even during the secondment, are in accord with the policy of the overseas company, who is their employer.
- For similar reasons, the orders of the CESTAT, affirmed by SC, in Volkswagen and Computer Sciences Corporation, are unreasoned and of no precedential value.
- Accordingly, SC held that the taxpayer was the service recipient of the overseas company, which can be said to have provided manpower supply service or a taxable service.
- CESTAT's reliance upon two of its previous orders and the fact that the Revenue discharged two SCNs, evidence that the view taken by the taxpayer was neither untenable, nor *mala fide*. Thus, Revenue was not justified in invoking the extended period of limitation.

## Comments

a. The ruling is likely to impact taxpayers negatively even though the Indian entity has a temporary employment agreement with the seconded person.

b. The industry may need to analyze the impact of the ruling in line with the contract clauses of the agreements entered between the group companies and the employee.

c. The ruling may also impact the position taken by the taxpayers for domestic deputation of employees within the group entities.

d. It may be important to evaluate the applicability of the ruling in cases where the employees are deputed to the group company and there is no contract for supply of any support services between the parties.

[7] (2018) 4 SCC 669

# Our offices

Ahmedabad
22nd Floor, B Wing, Privilon
Ambli BRT Road, Behind Iskcon
Temple, Off SG Highway
Ahmedabad - 380 059
Tel: + 91 79 6608 3800

Bengaluru
12th & 13th floor
"UB City", Canberra Block
No. 24, Vittal Mallya Road
Bengaluru - 560 001
Tel: + 91 80 6727 5000

Ground Floor, 'A' wing
Divyasree Chambers
# 11, O'Shaughnessy Road
Langford Gardens
Bengaluru - 560 025
Tel: + 91 80 6727 5000

Chandigarh
Elante offices, Unit No. B-613 & 614
6th Floor, Plot No- 178-178A
Industrial & Business Park, Phase-I
Chandigarh - 160 002
Tel: + 91 172 6717800

Chennai
Tidel Park, 6th & 7th Floor
A Block, No.4, Rajiv Gandhi Salai
Taramani, Chennai - 600 113
Tel: + 91 44 6654 8100

Delhi NCR
Golf View Corporate Tower B
Sector 42, Sector Road
Gurugram - 122 002
Tel: + 91 124 443 4000

3rd & 6th Floor, Worldmark-1
IGI Airport Hospitality District
Aerocity, New Delhi - 110 037
Tel: + 91 11 4731 8000

4th & 5th Floor, Plot No 2B
Tower 2, Sector 126
Gautam Budh Nagar, U.P.
Noida - 201 304
Tel: + 91 120 671 7000

Hyderabad
THE SKYVIEW 10
18th Floor, "SOUTH LOBBY"
Survey No 83/1, Raidurgam
Hyderabad - 500 032
Tel: + 91 40 6736 2000

Jamshedpur
1st Floor, Shantiniketan Building,
Holding No. 1
SB Shop Area, Bistupur
Jamshedpur – 831 001
Tel: + 91 657 663 1000

Kochi
9th Floor, ABAD Nucleus
NH-49, Maradu PO
Kochi - 682 304
Tel: + 91 484 433 4000

Kolkata
22 Camac Street
3rd Floor, Block 'C'
Kolkata - 700 016
Tel: + 91 33 6615 3400

Mumbai
14th Floor, The Ruby
29 Senapati Bapat Marg
Dadar (W), Mumbai - 400 028
Tel: + 91 22 6192 0000

5th Floor, Block B-2
Nirlon Knowledge Park
Off. Western Express Highway
Goregaon (E)
Mumbai - 400 063
Tel: + 91 22 6192 0000

Pune
C-401, 4th floor
Panchshil Tech Park, Yerwada
(Near Don Bosco School)
Pune - 411 006
Tel: + 91 20 4912 6000

Ernst & Young LLP

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