Analysis on Supreme Court Judgment in Northern Operating Systems – Upholding RCM on Manpower Supply for Secondment Employee

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Introduction:

On 19th May 2022, the Supreme Court delivered two judgments that shaken the foundations of indirect taxation. One in the matter of Mohit Minerals Private Limited[1], which struck down the levy of reverse charge on the importer for ocean freight services (for more on this, please read our article here[2]). Two, in the matter of Northern Operating Systems Private Limited[3], which upheld the revere charge on secondment of employees. Results of both the verdicts are opposite to the most popular public view, thus changing the way we look at the future of indirect taxation.

In this article, we wish to analyse the judgment of Supreme Court in the matter of Northern Operating Systems Private Limited (supra) and conclude with our remarks as to how the said judgment will impact the position under GST laws.

Issue in Brief:

The facts were that Northern Operating Systems Private Limited (for brevity respondent/NOS) was registered with service tax authorities under the categories of 'manpower recruitment agency service' and other services. An audit was conducted by revenue which resulted in the proceedings against NOS alleging non-payment of service tax concerning agreements entered into by it with its group companies located in USA, UK, Dublin, Singapore etc to provide general back office and operational support to such group companies.

The nature and contents of the agreements which are subject matter of current discussion reveal that when required NOS requests the group companies for managerial and technical personnel to assist in its business and accordingly the employees (seconded employees) are selected by group company and they would be transferred to NOS. During the term of secondment, the seconded employees act in accordance with the instructions and directions of NOS and the seconded employees would devote their entire time and work to NOS. The seconded employees would continue to be on the payroll of the group company (foreign entity) for purpose of continuation of social security/retirement benefits, but for all practical purposes, NOS is the employer. The seconded employees would receive the salary, bonus, social benefits, out of pocket expenses and other expenses from group company and the group company raises a debit note on NOS to recover the said expenses without any mark-up. NOS would be issuing prescribed forms under the provisions of Income Tax Act, 1961 for the seconded employees. The seconded employees file their returns in India and contribute to the provident fund.

The tax authorities alleged that NOS has failed to pay service tax under reverse charge for the services of manpower supply received from the group entities which are located outside India. The tax authorities contention was that the seconded employee would revert to the group entity once the

[1] [2022] 138 taxmann.com 331 (SC)
[2] 2022] 138 taxmann.com 360 (Article)
[3] [2022] 138 taxmann.com 359 (SC)

requirement with NOS is met. Hence, the seconded employee cannot be called as employee of NOS. Since there is no exclusion under the service tax law for a situation like which the NOS is in, there cannot be any relief from payment of tax under reverse charge. On the other hand, NOS argued that the group entities cannot be called as entities falling under the manpower recruitment or supply agency and after introduction of negative list, the definition of 'service' has excluded the services provided by employee to his employer from its ambit and since seconded employee is employee and NOS is the employer, their cannot be any tax either under pre or post negative list.

The CESTAT after hearing to both the parties, held that on reading of contracts and agreements, the group entities cannot be said to be engaged in supply of manpower. The seconded employees were receiving salaries from the group companies only for disbursement purposes and the employer – employee relationship existed and the activity, therefore, could not be termed as 'manpower recruitment and supply agency'. The CESTAT further held that in the above circumstances, the overseas group companies which had contracted with NOS were not in the business of supply of manpower and NOS was not a service recipient and accordingly rejected the stand taken by the tax authorities. The Revenue appealed the CESTAT's order before the Supreme Court.

Analysis by Supreme Court:

The Supreme Court after hearing to both the parties has framed the issue as to whether the overseas group companies with whom NOS has entered into agreement, provide manpower services, for discharge of its functions through seconded employees? In simple words, the Supreme Court has to decide, as to, who is the employer of the seconded employee? If the Indian entity is treated as employer, then what is paid to the group entity is only a reimbursement and accordingly there is nothing to be taxed. On the contrary, if the foreign entity is treated as employer of the seconded employee, then the services provided by the foreign entity would be treated as service and becomes taxable. Hence, the crux is, who is the employer of the seconded employee?

The Supreme Court after referring to its previous judgments, wherein it was held that 'control' alone cannot be a factor to decide as to who is the employer has stated that there is no one single determinative factor, which the courts give primacy to, while deciding, whether an arrangement is a contract of service (as NOS pleads) or a contract for service (as the revenue pleads). The Supreme Court stated that one test has been consistently applied by them, which is 'substance over form', requiring a close look at the terms of the agreement.

The Court then stated that a ***vital fact*** which needs to be considered in the NOS case, is that the nature of overseas group companies business appears to be to secure contracts, which can be performed by its highly trained and skilled personnel. This business is providing certain specialised services and taking advantage of the globalised economy, and having regard to the locational advantages, the overseas group company enters into agreements with its affiliates or local companies, such as NOS and the role of NOS is to optimise the economic edge to perform the specific tasks given to it, by the overseas company. As part of this, the secondment contract is entered into, whereby the overseas company's employees, possessing the specific required skill, are deployed for duration the task is estimated to be completed in. The Court stated it is in this context, it has to be decided, whether the secondment, for purpose of completion of the Indian entity's job, amounts to supply of manpower?

The Supreme Court stated that for all appearances, the seconded employees, for the duration of secondment, is under the control of NOS and works under its direction. The fact remains that they are on the payrolls of their overseas employer and 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. The

Court stated that it is doubtful whether without the comfort of this assurance, they would agree to the secondment. The Court further stated that, the reality is that the secondment is part of the global policy of the overseas employer loaning their services, on temporary basis and on cessation of secondment period, they have to be repatriated in accordance with the global repatriation policy. The Court further stated that the agreement between NOS and seconded employee nowhere states that latter would be treated as former's employees after the seconded period and on contrary, they revert to their overseas employer.

The Court thus stated that the overall effect of the four agreements entered into by NOS with group companies, 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 to the concerned Indian entity for the use of their skills and upon cessation of terms of secondment, they return to their overseas employer, or are deployed on some other secondment.

The Court stated that while control (over performance of seconded employee's work) and the right to ask them to return, if their functioning is not as is desired, is with NOS, the fact remains that their overseas employer in relation to its business, deploys them to NOS, on secondment. The Court further stated that overseas employer for whatever reason, pays them their salaries and their terms of employment even during the secondment are in accord with policy of overseas company, who is their employer and upon the end of period of secondment, they return to their original places, to await deployment or extension of secondment. Accordingly, the Court concluded that the overseas entity will continue to be the employer of the seconded employee and not the Indian entity.

The Court also rejected the argument put forward by NOS by stating that there was no consideration paid to the overseas entity (assuming that there is a service provided by overseas entity) and therefore no tax liability should accrue by stating that the mere payment in the form of remittances or amounts, either duration of the secondment, or per employee is just one of the way to reckon the consideration and the other way of looking at the arrangement is the economic benefit derived by NOS, which also secures specific job or assignments, from the overseas entities, which results in revenue and the quid pro quo for the secondment arrangement, where the NOS has benefits of the experts for limited period, is implicit in the overall things.

The Court also rejected the argument of revenue neutrality[4] by stating that the judgments relied upon by NOS of the same court are unreasoned and merely affirming the CESTAT Orders. Hence, those judgments relied upon by NOS does not have precedential value and accordingly NOS cannot escape tax based on the ground of revenue neutrality. The Court also rejected the reliance of NOS on earlier judgments of Supreme Court in the matter of Volkswagen India Private Limited[5] wherein it was held that the similar services provided by overseas entity is not a manpower recruitment and supply agency service by stating that such judgments are just confirmation of orders of CESTAT without any independent analysis and hence they do not have any precedential value.

[4] A situation where the tax if paid was available as input tax credit or refund and hence making non-payment of such tax should be considered as revenue neutral.

[5] 2014 (34) STR 135

Our Analysis:

As stated in the introduction of this article, this judgment is opposite to the most popular public view. There are series of judgments where in the tribunals have held that there cannot be any tax on similar transaction for the reason that the overseas entity cannot be called as manpower supplier and the employer shall be the Indian entity[6]. However, the Supreme Court overturned all such rulings by single stroke. The predominant reason that appears for the Supreme Court to arrive at above conclusion is the reliance on the judgment of Morgan Stanley & Co (MSCo)[7].

The Supreme Court in Morgan Stanley & Co (supra) was dealing with inter alia, a situation where an employee of MSCo when deputed to Indian entity Morgan Stanley Advantages Services Private Limited (MSAS) would constitute a service permanent establishment (PE) for MSCo in India? It was in this context the Supreme Court held that a deputationist has a lien on his employment with MSCo and as long as the lien remains with MSCo the said company retains control over the deputationist's terms and employment. The Court further stated that it is important to note that where the activities of multinational enterprise entails it being responsible for the work of deputationist and the employees continue to be on payroll of multi-national enterprises or they continue to have their lien on their jobs with multi-national enterprises, a service PE can emerge. By applying such rationale to the facts of MSCo, the Supreme Court held that there exists a service PE and accordingly concluded the income attributable to such service PE is taxable in India.

The point to ponder is whether the judgment of Supreme Court in the context of service PE can be used to determine, whether the employer would be the foreign entity or Indian entity for the purposes of service tax law. The existence of PE of a foreign entity in India is a factual exercise and changes from case to case. Even in the case of Morgan Stanley (supra), the court held that provision of stewards does not trigger service PE but provision of deputationist triggers. Hence, how far the adoption of such a judgment which deals with service PE can be applied to context of service tax law is not known. In addition to the above, when there exists a service PE, it can be said at the best, there was a provision of technical services by employees of MSCo to MSAS. However, in the instant case, the service tax was not charged under the category of technical services but under the category of manpower supplier.

Further, even under the direct taxation law, the seconded employees were treated as employees of the Indian entity. Though the overseas entity continues to be a legal employer, the Indian entity becomes an economic employer. OECD[8] in its commentary on model convention on Article 15[9], while dealing with who is to be treated as employer in international hiring-out of labour' stated that the term 'employer' was not defined in the convention but it is understood that the employer is the person having rights on the work produced and bearing the relative responsibility and risks. The commentary further stated apart from the above test, the contracting states have to refer to number of circumstances enabling them to establish that the real employer is the user of labour, like:

- The hirer does not bear the responsibility or risk for the results produced by employee's work
- The authority to instruct the worker lies with the user
- The work is performed at a place which is under the control and responsibility of user

[6] For reference, see recent ones in Komatsu India (P) Limited [2021] 131 taxmann.com 276 (Chennai – CESTAT), and Target Corporation India (P) Limited [2021] 123 taxmann.com 444 (Bangalore – CESTAT).
[7] [2007] 162 Taxman 165 (SC)
[8] Organization for Economic Co-operation and Development
[9] OECD Commentary on Article 15

- The number and qualifications of employees are not solely determined by hirer

On applying the above factors, it would be evident that the Indian entity is to be treated as employer and accordingly the services provided should have been out of service tax ambit. Further, there are numerous judgment under the direct taxation law, where it has been consistently held that Indian entity is the employer qua the seconded employees. Only in thin number of cases, where the consideration is paid to the foreign entity without any evidence that the same is again paid to seconded employees (Centrica India Offshore Private Limited[10] by Delhi High Court) or where there is an additional amount paid to foreign entity apart from the salary cost (AT&S India Private Limited[11]), the courts have held that the said amounts are for provision of technical or other services and not the reimbursement of cost of seconded employees.

The Supreme Court though stated that there cannot one test for determination as to who the employer is, but ruled out that the Indian entity cannot be employer for the only reason that he exercises the control on the seconded employee. Though the agreement between NOS and its group entities clearly states that the seconded employee would be on the payrolls for the overseas entities only for purposes of salary disbursement and nothing else was set aside by stating that they have adopted the substance over form approach. The Court nowhere stated why the agreements should be discarded and a substance over form approach is to be adopted. The Court has completely ignored the fact that the seconded employees have been issued tax forms in India which shows the intent of NOS to treat them as employees of NOS and concluded that the overseas entity will continue to be the employer of the seconded employee only for the reason that there exists a lien on such employment and seconded employee continues to be on payroll of the overseas entity. This pick and choose approach of Supreme Court with due respects requires a re-consideration.

The Court instead of rejecting the reliance on Volkswagen India Private Limited (supra) and others should have gone into detail as to what the high courts or CESTATs have held on similar issue and then should have concluded regarding the taxability. To this extent, the conclusion of the Supreme Court in the matter of NOS may require a re-consideration.

Further, another point that requires consideration is, whether the judgment of Supreme Court in NOS (supra) is universally applicable for all secondment cases or the Supreme Court did draw a distinction? Para 52 of the judgment states that a vital fact that needs to be considered in the NOS case is that the overseas entities are engaged in securing contracts which are then outsourced to NOS and later performed by deputed/seconded employees. In this context, the Court framed a question that whether the secondment, for the purpose of completion of NOS's job, amounts to manpower supply? The Court also stressed on the role of NOS to be optimising the economic edge to perform the specific task given to it, by overseas companies.

Taking clue from the above, can we state that the employer will be the overseas entity, only in cases where the Indian entity places request for seconded employees for completion of specific tasks which are outsourced by overseas entity to Indian entity? In simple words, where seconded employees are not engaged in any specific activity or involved in day to day management, can they stand exclude by the judgment in NOS (supra). This question assumes significance especially, when seen in the context of facts of Morgan Stanley (supra). In the said case, MSCo sent two sets of employees to MSAS. One, the

[10] [2014] 364 ITR 336 (Delhi)
[11] 287 ITR 421

stewards and two, the deputationists. The AAR[12] in MSCo case held that MSCo sending both the sets of employees to MSAS triggers service PE for the former. However, the Supreme Court after analysing the activities of stewards, stated that the activities of steward are in the nature of merely protecting MSCo's interest in the competitive world by ensuring, the quality and confidentiality of MSAS services. Hence, the Court held that there cannot be said that by providing stewards MSCo has actually provided a service to MSAS. Then, the Court moved on to the analysis of provision of deputationists and as discussed earlier, held that the provision of such employees would trigger service PE for MSCo.

Hence, on a close reading of the judgment of NOS (supra) and Morgan Stanley (supra), it appears that only in cases where the secondment employees are taken for completion of specific task which earns a direct revenue to the Indian entity, such cases will alone be falling for the payment of tax under reverse charge. However, whether this is the interpretation of the Supreme Court or not has to be waited and seen in the times to come.

Position under GST Laws:

Though the above judgment was delivered in the context of service tax law, it is important to examine the impact that it will have under the GST laws. Similar to the exclusion from the definition of 'service', the services provided by employee to employer in the course of or in relation to his employment was specified as Entry 1 in Schedule III to Section 7 of CT Act to be an activity or transaction which shall be treated neither as supply of goods or services or both. Hence, the services provided by employee to his employer are also not subjected to tax under GST laws. However, the prime question that who is to be treated as employer, the foreign entity or Indian entity remains unanswered.

Taking clue from the judgment of Supreme Court in NOS (supra), the overseas entity would be the employer, there by the service provider. In terms of Section 13(1) and 13(2) of IT Act[13] read with Entry 1 of Notification No 10/2017 – CT (R), the tax is required to be paid by the service recipient under reverse charge. Further, the argument that there is no separate fee or consideration charged by the overseas entity and hence there cannot be any tax (argument taken by NOS before Supreme Court) will fail under the GST laws in light of Entry 2 of Schedule I to Section 7 of CT Act. The said entry states that the activity of supply of services when made in course or furtherance of business between related person shall be treated as supply even when there is no consideration. Assuming that the overseas entity and Indian entity falls under the definition of 'related person' as laid down vide Explanation (a) to Section 15, then the activity shall be treated as supply dehors the fact there is no consideration. The value of supply has to be determined by the rules which deal with valuation. On the other hand, if the employer is treated as Indian entity being the economic employer, then the services provided by seconded employee would not be subjected to tax.

Therefore, in all instances where the activity of the seconded employee is not in achieving a specific task or job of the Indian entity, then there will be a high chance that the taxpayer need not pay tax under reverse charge by placing reliance on NOS (supra). In instances where the activity of seconded employee is directly related to achieving a specific task or job, then there is a high chance for the tax authorities to demand tax under reverse charge from the Indian entity. If the Indian entity is in a situation that it is eligible for credit, it is advisable on a conservative basis to remit the tax and avail as credit. In cases, where Indian entity is not in a situation to avail the tax paid as credit, then it has to prepare to face the litigation.

[12] Authority for Advance Ruling
[13] Integrated Goods and Services Tax Act, 2017

From the above analysis it is evident that, if a review petition is filed before the Supreme Court, the chances of change in the outcome of the judgment are high. Assuming that the review petition fails, then there will be a second round of litigation, where the concept of economic employers and other connected matters will be tested. Till then, this twist in the story continues to effect the Indian entities.