International, India

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Morgan Stanley: Issues regarding Permanent Establishments and Profit Attribution in Light of the OECD View

This article examines the 2007 judgement of the Supreme Court of India in *Morgan Stanley* from the attribution side of Art. 7 and from the perspective of the permanent establishment (PE) triggering factors in Art. 5. Before examining the decision, the article reviews some OECD developments, including the "all determinative" functions which serve as the magnet for assets, risks and capital; agency PEs and administratively simplified assessments; and double taxation relief. The article also discusses the 2007 decision of the Income Tax Appellate Tribunal of Mumbai in *SET Satellite*.

1. Introduction

These are exciting times. Soon the new OECD view on the attribution of profits to permanent establishments (PEs) will be included in the Commentary (non-binding legal system) on Art. 7 of the OECD Model Tax Convention. What will judges, as the ultimate treaty interpreters, do with the new OECD view? Will they, despite the non-binding nature of the Commentary, be inspired by the new methodologies? Can the judges accept the axioms of the system? Or will they stick to their traditional treaty interpretation which, in many cases, may differ from the OECD methodologies? Will a more uniform treatment of PE profits arise internationally?

As there is little indication of the acceptability to judges of the OECD methodologies as laid down in the 2006 IFA Report on the attribution of profits to PEs (2006 IFA Report),[1] any judgement, from whatever jurisdiction, is of great value. In our open international society, the international tax community, judgements from all jurisdictions are eminently important and a source of – positive or negative – inspiration to members of the community.

In the context of profit attribution, India's recent judgements in the *SET Satellite* and *Morgan Stanley* cases set the tone. *SET Satellite* clearly supports the OECD approach, but on *Morgan Stanley* the general opinion is that it reflects the single taxpayer approach.[2] It seems that the Delhi Income Tax Appellate Tribunal also has the same view, considering its 2007 ruling in *Galileo International*.[3] This author, as a non-Indian, should perhaps be more reluctant to interpret an Indian judgement, but based on a close reading of the Supreme Court's decision, it must be regarded as favouring the OECD dual taxpayer approach,[4] and not so much as confirming the single taxpayer approach.

This article discusses (in Part 2) where the OECD now stands as to certain aspects of profit attribution and describes the axiom of the OECD system: the "all determinative" functions, which serve as the magnet for assets, risks and capital. In the OECD view, the functions are the whirlpool that draws the related assets, risks and capital into the PE jurisdiction. Part 2 also outlines the OECD view on the attribution of profits to an agency PE (which is basically no different from the attribution of profits to other types of PEs) and discusses the OECD view that a treaty is not prescriptive as to which person is taxed on the PE profits and that there is nothing against

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1. General Report on Subject II: The attribution of profits to permanent establishments, 91b *Cahiers de droit fiscal international* (2006) (60th Congress of the International Fiscal Association, Amsterdam, 2006). According to the General Report (at 50 and 51), a slight majority of the national reporters was against the OECD dual taxpayer approach.

2. The literature generally defends the view that the Supreme Court's judgement in *Morgan Stanley* is against the dual taxpayer approach. See Vogel, Klaus, "Tax Treaty News", *Bulletin for International Taxation* 11 (2007), at 474-475; Fazelbhoy, Aliff and Farah Petiwalla, "Ruling that Domestic Subsidiary of US Company Constitutes a Permanent Establishment", *International Transfer Pricing Journal* 1 (2007), at 59; Mitra, Rahul Krishna and Sanjay Tolia, "BPO units in India: Recent Supreme Court ruling in the case of *Morgan Stanley* on PE & Profit attribution", *Tax Planning International Review* 7/07, at 12-15; Jain, Parul and Shefali Goradia, "India: Landmark outsourcing ruling in *Morgan Stanley*", *Tax Planning International Transfer Pricing* 8/07, at 2; and Tanikella, Jitender and Bijal Ajinkya, "*Morgan Stanley*: Indian Supreme Court's Landmark Ruling on PE, Transfer Pricing and Attribution of Profits", *Worldwide Tax Daily*, 2007 WTD 142-5.

3. *Galileo International Inc. v. Deputy Commissioner of Income Tax, Non-Resident Circle, New Delhi*, 30 November 2007. In Para. 9, the Income Tax Appellate Tribunal (ITAT) discussed the question of how much income was chargeable to tax in India under its domestic law. Based on the facts, it held that 15% of the income from the bookings made in India was to be considered as income arising in India. In Para. 10, the ITAT discussed how much income was left to be taxed in India. This income was the income (15% of USD 3) minus the amount paid to the agent Interglobe (USD 1); therefore, the remuneration paid to Interglobe consumed the entire income. The ITAT summarized the Supreme Court's *Morgan Stanley* decision as follows: "The Hon'ble Supreme Court ... have held that once [an] associated enterprise which is considered as [a] PE of the non-resident assessee is remunerated at arms-length, nothing further would be left to be attributed to the PE of the non-resident." In Para. 18 (dealing with attribution under the treaty), the same 15% of income was attributed to the PE; also there, it was concluded that the payment to Interglobe extinguished the tax liability of Galileo International.

4. This view was also defended by Michael Lennart at the International Taxation Conference in Mumbai (November/December 2007).

a domestic system that taxes the profits in the hands of the PE triggering agent.

Part 3 discusses the *SET Satellite* case and its clear choice for the dual taxpayer approach.

Part 4 concentrates on the *Morgan Stanley* case and examines the judgement both from the attribution side of Art. 7 and from the perspective of the PE triggering factors in Art. 5. The constitution of a PE is, as a consequence of the open terms in Art. 5 (which allow various interpretations), an issue that is – necessarily at this stage of no international consensus – strongly coloured by local views and traditions; thus, criticism is out of the question as an inappropriate way of discussing a judgement. This article merely considers from a neutral perspective the Supreme Court's reasoning against the backdrop of the normative system of the OECD Commentary. Part 5 contains the summary and conclusions.

2. OECD Developments

The core approaches in the OECD Report on the Attribution of Profits to Permanent Establishments (December 2006) (Report) have been incorporated into the Draft Revised Commentary on current Art. 7 of the OECD Model (10 April 2007) and will also become a part of the Commentary on revised Art. 7, which will, as can be expected, follow the concepts in the Report to the full extent. The draft of the Commentary on revised Art. 7 was not available at the time of writing.

Two of the core approaches deserve attention in light of the *Morgan Stanley* case. The first is the "all determinative" role of the functions, which serve as the observable, empirical starting point for the attribution of risks, assets and capital to a PE. The second approach is how the OECD deals with the attribution of profits to an agency PE.

2.1. Functions as the magnet

The Report follows a two-step approach. In the first step, the PE, in a concrete situation, is supplied with the relevant characteristics of a distinct and separate enterprise. In the first step, two sub-steps are to be distinguished: (a) the PE is "postulated as a distinct and separate enterprise", i.e. this sub-step determines what type of enterprise the PE is (Report, Paras. 86-206); and (b) it has to be determined whether dealings (between the PE and head office or between the PE and other PEs) have taken place and whether the dealings may be recognized (Report, Paras. 207-217). In the second step of the two-step approach, the arm's length prices for the dealings are determined (Report, Paras. 218-259).

The first sub-step starts with a functional and factual analysis (Report, Para. 90 et seq.) in which the significant people functions are determined. In this analysis, the functions performed elsewhere on behalf of the PE are also taken into account.[5]

The Report then, still in the context of hypothesizing the PE, continues with the attribution of risks (Paras. 97-100), (economic) ownership of assets (Paras. 101-129) and free capital (Paras. 130-148), and axiomatically bases the attribution of risks (and free capital that, in turn, follows the risks) and assets on where the functions are performed. Transactions with third parties are attributed to the PE when its functions justify this (see e.g. Report, Para. 207).

Because the attribution of risks is heavily function orientated, a dealing between parts of the enterprise whereby the initially attributed risks are transferred requires a shift in the functions, in the view of the Report (Para. 99):

> ... a risk may be considered transferred to another part of the enterprise if there is documentation evidencing the intention to engage in a "dealing" in the form of a transfer of the risk to that other part, and that other part thereafter performs the significant people functions relevant to the management of the risk. ... a part of the enterprise which has not initially assumed a risk cannot be deemed to have subsequently taken over the risk unless it is also managing the risk. ... risk cannot be separated from function under the authorized OECD approach.

These sentences pre-empt what is systematically the subject of the second sub-step (Report, Para. 207 et seq.): internal transactions/dealings between the various parts of the enterprise. Here, in the OECD view, there are some limitations on the distinct and separate enterprise fiction, which the Report justifies by referring to the lack of legal consequences of an internal dealing and to the difference between a subsidiary (separate in reality) and a PE (part of the same enterprise) (Report, Para. 210). Similar arguments have been made before in the Commentary: internal interest, good management and internal royalties are thus also reflected in the Draft Revised Commentary. As to internal interest, for example, Para. 38 of the Draft Revised Commentary still provides that

5. This is not to say that the profits connected to the functions performed elsewhere will, as a rule, be taxed in the PE state. In the 2004 Discussion Draft, this was perhaps less clear; see the last sentence of Para. 80, which was dropped in the corresponding paragraph in the 2006 Report: "In many cases, all the activities necessary to carry on the business through a fixed place take place within the PE's host country. For example, the PE may act as a distributor and carry on all the associated activities, including market research, in its jurisdiction. However, it is important that the functional analysis includes not just activities taking place in the jurisdiction of the PE, but all activities performed on behalf of the PE and all activities performed by the PE on behalf of other parts of the enterprise. In another case, a functional analysis may show that some activities necessary to carry out the distribution function, say market research, are performed in a different jurisdiction. Such activities will have to be taken into account when attributing profit to the PE, although the exact manner of doing so will depend on an analysis of the facts and circumstances."

The Report confirms that the ultimate profit attribution itself follows, as a general rule, a territorial approach (the PE's income is determined on the basis of the functions performed in the PE state). See e.g. Para. 97 of the Report: "... under the authorised OECD approach it is possible to treat the PE as assuming risk, even though legally the enterprise as a whole assumes the risk and there can be no legally binding contractual arrangements allocating that risk to a particular part of the enterprise. The PE should be considered as assuming any risks for which the significant people functions relevant to the assumption of risk are performed by the personnel of the PE at the PE's location. For example, the PE should, generally, be treated as assuming the risks arising from negligence of employees engaged in the function performed by the PE." See also Para. 267 of the Report: "... the quantum of that profit is limited to the business profits attributable to operations performed through the dependent agent PE in the host country." On the other hand, this is not to say that the activities performed by the PE's personnel abroad, e.g. at the head office, should not be included.

"the ban on deductions for internal debts and receivables should continue to apply". (The Draft Revised Commentary makes similar statements for good management (Para. 34) and internal royalties (Para. 30).) Regarding the further linguistic environment ("need for greater scrutiny of dealings" in Report, Para. 210, and "partial results may well be arbitrarily changed" in Draft Revised Commentary, Para. 38), this approach seems inspired, at least in part, by fear of allegedly abusive shifts of profits, which is confirmed by the Report's accompanying mention of Paras 1.37-1.38 and 1.25-1.29 of the OECD Transfer Pricing Guidelines. As to the Draft Revised Commentary, the question is whether the "real and identifiable event" (Report, Para. 212), i.e. an event that has an economic meaning, would not be a better benchmark considering the text of the treaty, instead of a categorical no.

The Report also dooms some dealings: those relating to creditworthiness and guarantee fees are, as a matter of principle, not accepted. It is argued that this is not discriminatory (compared to two separate legal entities) since there is a fundamental difference in legal form and since internal dealings lack economic substance (Report, Paras. 130-135). The question regarding the scope of the distinct and separate enterprise fiction, therefore, is still very much alive, and case law will continue to draw the borders.

In the context of a typical agency PE, the above means that a functional analysis will take the functions of the agent as determinative. In the first place, the agent's functions will be considered the functions of the PE. In the second place, the risks and assets relating to the functions which hover undetermined in the enterprise will be drawn by those functions into the PE. If the agent performs qualifying credit activities, the credit risk will be the PE's. If the agent performs qualifying activities relating to the stock, the obsolescence risk will be the PE's. If the agent performs promotional activities to such an extent that they lead to an intangible, the PE will have economic ownership of that intangible. Shifts of the risks and assets that primarily, in the first sub-step, are those of the PE can be accepted only if the head office (or another part of the enterprise) performs the relevant functions (Report, Paras. 266-275).

Though it is awaited whether the axiom (risks follow functions, assets follow functions, capital follows risks) will be accepted in case law, the OECD approach has a good chance to survive: Art. 7 prescribes an economic approach ("attributable" and "attributed" have an economic meaning), and a acceptable explanation is that no one takes risks which are beyond his control and whose management is not his function.

2.2. Agency PE and administratively simplified assessments

The wording of the agency article (Art. 5(4)) of the 1963 Draft OECD Model differed from the wording of current Art. 5(5) of the OECD Model. Art. 5(4) provided: "A person acting in a Contracting State on behalf of an enterprise of the other Contracting State ... shall be deemed to be a permanent establishment in the first-mentioned State if he has, and habitually exercises in that State, an authority to conclude contracts in the name of the enterprise ...." In 1977, Art. 5(5) received its current wording in order to clarify that Art. 5(5) stipulates the conditions under which an enterprise is deemed to *have* a permanent establishment in respect of *any activity of a person acting for it*.[6] The 1963 version equated the PE triggering agent with the agency PE; in contrast, the 1977 version distinguished the agent from the PE it caused. Although the purpose of the 1963 version was clearly the same as that of the 1977 version, the 1977 text better reflects the existence of two taxpayers: the PE triggering agent and the foreign enterprise.

Art. 5(1) (including Art. 5(3)) and Art. 5(5) of the OECD Model have a similar purpose: when the PE threshold is surpassed, all activities done through that PE are within the taxing rights of the PE state. In Art. 5(1), this "including effect" is expressed in the phrase "a fixed place of business *through* which the business of an enterprise is wholly or partly carried on" (emphasis added); in Art. 5(1), the place of business serves as the magnet for attracting every activity to it that is done "through" it. Art. 5(1) therefore uses the place of business as a geographical connecting factor. In Art. 5(5), regarding the "person" that triggers the PE, another connecting factor had to be used to achieve the same effect because a geographical factor did not make much sense there. The connecting factor became the functional criterion of the activities undertaken by that person for the enterprise: that enterprise shall be deemed to have a PE in respect of any activities which that person undertakes for the enterprise. As a result, in both paragraphs, the scope of the activities that are attracted to a PE is broader than the PE creating factors themselves justify.

Although the 1977 version of Art. 5(5) reflects the presence of two relevant potential taxpayers in the PE state (agent and agency PE), its text is clearly not the basis of the dual taxpayer approach. Nor does the 1977 version of Art. 5(5) say anything about the profits that can be attributed to the agency PE. Although this may be clear, suggestions have been made that Art. 5(5) limits the amount of attributable profits.[7] In addition, neither the 1963 nor the 1977 text says anything about the person who should be assessed on the enterprise's profits. Notwithstanding that the 1963 text defines the agent as the PE itself, the definition of the relevant taxpayer for the enterprise's PE profits is left to domestic law. Although in the majority of instances the taxpayer will be the foreign enterprise, the domestic law, case law or practice can make another person relevant for administrative matters.

6. Para. 30 of the 1977 Commentary on Art. 5.
7. See Pijl, Hans, "The Zero Sum Game, the Emperor's Beard and the Authorized OECD Approach", *European Taxation* 1 (2006), at 29, in which the author analysed this view and argued that such suggestions are incorrect.

Therefore, if, under the domestic law of the PE state, the enterprise's profits are taxed in the hands of a person other than the enterprise, this is not in breach of the treaty as the treaty leaves this to the sovereignty of the state in question. The treaty is not about the mode and timing of taxation; it is merely an instrument that authorizes the taxation of certain (economic) amounts of income in a state. As a practical matter, sometimes it is the administrative practice, not the domestic law, that defines the person to be assessed. A good example is the former practice in the United Kingdom, where in the past the tax authorities accepted not to assess the taxpayer, but to tax the agent on an amount equal to (a) its own agency profit and (b) the PE profits of the enterprise. In conformity with this, Para. 282 of the Report accepts such methods:

> ... nothing in the authorized OECD approach would prevent countries from using administratively convenient ways of recognizing the existence of a dependent agent PE and collecting the appropriate amount of tax resulting from the activity of a dependent agent. For example, where a dependent agent PE is deemed to exist ..., a number of countries actually collect tax only from the dependent agent enterprise even through the amount of tax is calculated by reference to the activities of both the dependent agent enterprise and the dependent agent PE.

This means that the agent is taxed on its own profits (from its agency activities) and on the profits of the agency PE. The Report (Para. 282) continues:

> In practice what this means is taxing the dependent agent enterprise not only on the profits attributable to the people functions it performs on behalf of the non-resident enterprise (and its own assets and risks), but also on the reward for the free capital which is properly attributable to the PE of the non-resident enterprise.[8]

In general, whether a profit remains at the PE level after deducting the remuneration of the agent (whether an employee or other contractor) therefore depends on whether there is a difference between the arm's length remuneration of the agent (which, in many cases, will be determined purely functionally) and the PE profits (which will include a mark-up for the risks, assets and capital inherent to those functions). Thus, if the agent's activities are unrelated to the management of the enterprise's risks, no risks will be attributed to the PE, and the PE profits will be close to zero. Indeed, the remuneration of the agent and the PE profits are then equal.

2.3. Double taxation relief

The Report (Para. 282) concludes with a sentence which is new compared to the corresponding paragraph (Para. 286) of the 2004 Discussion Draft, Part I. The new sentence provides:

> It follows that the home country with a PE in a host country that operated such an administratively convenient procedure would not be obliged to give relief or entitled to tax on the basis that there was no dependent agent. The taxing rights of the home country are not altered by administratively convenient procedures of the host country.

This sentence is perhaps not completely unambiguous, but what it purports to say is that the home state would *be obliged to give relief* and would *not be entitled to tax* on the basis that there is no PE.

3. *SET Satellite*

In the *SET Satellite* case,[9] SET Satellite (Singapore) Pte Ltd was a resident of Singapore for purposes of the India–Singapore tax treaty. SET Satellite was in the business of creating and operating satellite television channels and marketing and distributing them in India. SET Satellite had an agent in India to market airtime slots to advertisers there. Since the conditions of the agency provision, Art. 5(8)(a), of the treaty were satisfied, SET Satellite had a PE in India. The agent was remunerated on an arm's length basis.

After a lengthy discussion of the positions taken by the Australian Tax Office, by the OECD and in the relevant literature, especially the 2006 IFA Report, the Income Tax Appellate Tribunal of Mumbai ruled as follows (Paras. 29 and 31):

> The above observations clearly show that there is a widely held school of thought, even amongst the tax advisors who tend to take liberal interpretations in favour of the taxpayers and who easily outnumber and outweigh neutral members in bodies like IFA, that there has to be profit attributed to the dependent agent permanent establishment over and above the arm's length fees paid to the dependent agent. Having given our careful consideration to the matter, we also subscribe to this school of thought. ...
>
> In view of the above discussions, we are of the considered view that the tax liability of a foreign enterprise, in respect of its dependent agency permanent establishment, is not extinguished by making an arm's length payment to the dependent agent.

4. *Morgan Stanley*[10]

4.1. Facts and issues

Morgan Stanley and Co. Inc (MSCo) was a resident of the United States, and one of the group companies, Morgan Stanley Advantage Services Private Limited (MSAS), was a resident of India. MSAS provided services, which contractually were consistently defined as "support services", to MSCo's front office activities, such as IT support, account reconciliation, and research – a total of 17 types of services. These activities were characterized as "back office activities". MSCo, in turn, instructed MSAS on the standard of services expected and informed MSAS's staff of the tasks to be performed by conducting briefing sessions so that MSAS's services would meet the overall global benchmarks of the Morgan Stanley group. These "stewardship activities" also included monitoring

8. In light of the OECD attribution of profits to an agency PE sketched elsewhere in the Report's agency PE paragraphs, it must be assumed that the profits of that PE exceed the agent's profits not only because of the attribution of free capital to the PE, but also because of the risks and assets it economically has. Risks and assets therefore are also included in the numbers game. As Para. 268 of the Report explains: "... the dependent agent PE will be attributed the assets and risks of the non-resident enterprise relating to the functions performed by the dependent agent enterprise on behalf of the non-resident, together with sufficient 'free' capital to support those assets and risks."
9. Income Tax Appellate Tribunal of Mumbai, 20 April 2007.
10. Supreme Court of India, 9 July 2007.

the overall operations of MSAS. In order to ensure that no material exposure arose from the investors' perspective, MSCo's personnel travelled to India for a "very short term". In addition, MSCo's staff was hired out to MSAS for periods ranging from several months to a few years to work under MSAS's supervision ("secondment activities"). The staff would continue to be legally employed by MSCo, the salaries would continue to be paid by MSCo, and MSAS would reimburse the salaries without a mark-up.

The consideration paid by MSCo was the cost, plus a mark-up of 29%. The mark-up was based on a transfer pricing study; the arm's length character of the remuneration was not under discussion.

The issues were whether the various activities of MSAS and MSCo triggered a PE and whether the 29% payment extinguished MSCo's tax liability in India. In other words, if a PE was triggered, did the PE have additional profits which could be taxed, where MSAS was already taxed on an arm's length remuneration?

Art. 5 of the 1989 India–United States treaty provides:

> 1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.
>
> 2. The term "permanent establishment" includes especially: (a) a place of management; (b) a branch; (c) an office; (d) a factory; (e) a workshop; ... (l) the furnishing of services, other than included services as defined in Article 12 (Royalties and Fees for Included Services), within a Contracting State by an enterprise through employees or other personnel, but only if: (i) activities of that nature continue within that State for a period or periods aggregating more than 90 days within any twelve-month period; or (ii) the services are performed within that State for a related enterprise (within the meaning of paragraph 1 of Article 9 (Associated Enterprises)).
>
> 3. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include any one or more of the following:
> (a) the use of facilities solely for the purpose of storage, display, or occasional delivery of goods or merchandise belonging to the enterprise;
> (b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display, or occasional delivery;
> (c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
> (d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise;
> (e) the maintenance of a fixed place of business solely for the purpose of advertising, for the supply of information, for scientific research, or for other activities which have a preparatory or auxiliary character, for the enterprise.
>
> 4. Notwithstanding the provisions of paragraphs 1 and 2, where a person – other than an agent of an independent status to whom paragraph 5 applies – is acting in a Contracting State on behalf of an enterprise of the other Contracting State, that enterprise shall be deemed to have a permanent establishment in the first-mentioned State if:
> (a) he has and habitually exercises in the first-mentioned State an authority to conclude contracts on behalf of the enterprise, unless his activities are limited to those mentioned in paragraph 3 which, if exercised through a fixed place of business, would not make that fixed place of business a permanent establishment under the provisions of that paragraph; ...
>
> 5. An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other State through a broker, general commission agent, or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business. However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise and the transactions between the agent and the enterprise are not made under arm's-length conditions, he shall not be considered an agent of independent status within the meaning of this paragraph.

Arts. 7(1) and (2) read:

> 1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to (a) that permanent establishment; (b) sales in the other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment; or (c) other business activities carried on in the other State of the same or similar kind as those effected through that permanent establishment.
>
> 2. Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly at arm's-length with the enterprise of which it is a permanent establishment and other enterprises controlling, controlled by or subject to the same common control as that enterprise. In any case where the correct amount of profits attributable to a permanent establishment is incapable of determination or the determination thereof presents exceptional difficulties, the profits attributable to the permanent establishment may be estimated on a reasonable basis. The estimate adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.

4.2. Issues under Art. 5 of the India–US treaty

4.2.1. Back office activities

4.2.1.1. Art. 5(1) in conjunction with Art. 5(3)

The issue here was whether the service agreement between MSCo and MSAS led to a PE. As to Art. 5(1) of the treaty, the Authority for Advance Rulings (AAR)[11] took a straightforward position (Para. 9): "The place of business of MSAS is no doubt a fixed place but there is nothing to show that the business of the applicant, noted above, is carried on through the place of business of MSAS." Since the subjective link between the objective place of business and the enterprise was not established, no PE arose. The OECD Model phrases this in terms of "at the disposal of". Although this phrase is not literally in Art. 5(1) of the OECD Model, the phrase is discussed extensively in the Commentary as a basic requirement

11. Authority for Advance Rulings, New Delhi, 13 February 2006.

for a PE under Art. 5(1) and could be considered inherent in the treaty phrase "carry on business through".[12]

In its judgement of 9 July 2007, the Supreme Court of India stated in Para. 8 (first sentence): "In our view, the second requirement of Article 5(1) of DTAA is not satisfied as regards back office functions." At first glance, this appears to say that MSCo was considered not to carry on business through the Indian place of business, but in what followed in Para. 8, it seems that the auxiliary nature led the Supreme Court to its judgement: "It is from that point of view, we are in agreement with the ruling of the AAR that in the present case Article 5(1) is not applicable as the said MSAS would be performing in India *only* back office operations. Therefore to the extent of the above back office functions the second part of Article 5(1) is not attracted" (emphasis added). It thus seems that – whether or not MSCo had a place of business at its disposal – in the Indian interpretation, Art. 5(3) of the treaty has a bearing on the element "carry on business through" in Art. 5(1).[13] This is not in line with the OECD view, in which Art. 5(4) of the OECD Model is an exception to the independently tested Art. 5(1) and in which the final part of Art. 5(1) is to be analysed on the basis of criteria separate from those in Art. 5(4).

4.2.1.2. Art. 5(3)

The contract between MSCo and MSAS consistently described the activities done for MSCo as being of a supportive nature. In its judgement (Para. 3), the Supreme Court described the activities as supporting MSCo's "main office functions in equity and fixed income research, account reconciliation and providing IT enabled services such as back office operation, data processing and support centre to MSCo". The AAR ruling quoted part of the contract, which contained an extensive description of the various types of services. The Supreme Court considered them as auxiliary for treaty purposes. As a factual issue, there is not much that can be added to this in light of the open criteria for distinguishing core activities from auxiliary activities in the OECD Commentary.

The Commissioner's counsel, however, argued that:

> MSAS performs essential and significant activities of the Morgan Stanley [group], which are crucial and critical for the business being carried on by the applicant as well as the other group companies, the development of computer software including customized electronic data or product or computer programme are also of critical relevance for the applicant and the group. It is on the basis of the material research support, data analysis etc. that the applicant formulates its business strategy and ensures, inter alia, that profits in the share portfolio and fixed income portfolio of customers are increased. MSAS would necessarily have business interface on an ongoing basis with vendors of information in the market and have regular contacts with various sources in India for getting the required data and information and other industry specifics for preparing its research reports, review etc. and thus develop in India a network of contacts and sources relating to relevant industry etc. Therefore, the functions performed by MSAS are essential core functions for the enterprise and cannot be described preparatory and auxiliary in nature.

Attractive as this may sound, there is nothing in the OECD Commentary that would – setting aside the evaluation of the facts – have led to another conclusion.

4.2.1.3. Art. 5(4)

The Commissioner's counsel also argued that MSAS was a dependent agent of MSCo, but did not argue that the PE constituting elements of Art. 5(4) of the treaty were met. It is as if he argued from the non-application of the exception in Art. 5(5). He seemed to realize the weakness of this approach since he suggested that the testing of the strict criteria in Art. 5(4) be substituted by a more conceptual approach: "Further, the contention that MSAS does not have any authority to conclude any contract on behalf of the applicant as such the requirement of para (4) of article 5 is not fulfilled, ignores the commercial reality of the situation and all these facts show that MSAS is not an independent agent."

The Supreme Court did not agree and, in Para. 9 of its judgement, it gave Art. 5(5) the status of exception by holding that "as rightly held by the AAR there is no agency PE as the PE[14] in India had no authority to enter into or conclude the contracts. The contracts would be entered in the United States. They would be concluded in the US". The relationship between Arts. 5(4) and (5) of the treaty, as the main rule and exception, is in conformity with the OECD view (Para. 36 of the Commentary on Art. 5 of the OECD Model).

4.2.2. Stewardship activities

In Para. 14 of its judgement, the Supreme Court rejected the AAR view that the stewardship activities led to a service PE under Art. 5(2)(l) of the India–US treaty. The Court reasoned that, in performing the stewardship activities, MSCo was not performing a service for MSAS, but was merely protecting its own investment and controlling whether MSAS's services were performed in conformity with the Morgan Stanley standards. In other words, no service was performed for a third party; MSCo was merely carrying on its own business.

12. It does not appear that any weight was given to the contention of the Commissioner's counsel (Para. 7 of the AAR ruling) that "clauses 9.2 and 9.3 show that there is *unrestricted access to the premises of MSAS* and this shows that MSAS is working for and on behalf of the applicant and is a mere projection of the applicant and the group" (emphasis added).

13. Art. 5(3)(e), quoted above in 4.1., uses "solely" and "or". This raises the question whether the breakdown of the activities still brings their combination into Art. 5(3)(e). The UN Model is not of much assistance on this point because, regarding combinations of activities, the UN Model has the special provision of Art. 5(4)(f). The US Technical Explanation of the India–US treaty clarifies that the US view is that combinations of activities under Art. 5(3)(e) do not qualify as a PE: "A combination of these activities will not give rise to a permanent establishment." See US Treasury Department, "Technical Explanation of the Convention and Protocol between the United States of America and the Republic of India for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income signed at New Delhi on September 12, 1989."

14. In the author's view, from the textual perspective of Art. 5(4), the better term would have been "person".

The OECD view would be the same if one takes into account Para. 42.30 of the OECD Services Discussion Draft of 6 December 2006:

> The provision applies to services performed by an enterprise. Thus, services must be provided by the enterprise to third parties. Clearly, the provision could not have the effect of deeming an enterprise to have a permanent establishment merely because services are provided to that enterprise. For example, services might be provided by an individual to his employer without that employer performing any services (e.g. an employee who provides manufacturing services to an enterprise that sells manufactured products).

4.2.3. Secondment activities

4.2.3.1. Art. 5(2)(l) of the India–US treaty

MSCo's staff was sent on secondment upon MSAS's request for periods ranging from several months to a few years to work under MSAS's control and supervision. From an employment contract perspective, the staff continued to be employed by MSCo, which also paid their salaries. MSAS reimbursed their salaries to MSCo with no profit element. The secondment took place over a two-year period; the secondees returned home after fulfilling their work in India and were expected to be experienced in banking and finance.

The Supreme Court ruled (in Para. 15 of its judgement) that the facts gave rise to a service PE under Art. 5(2)(l) of the treaty: "It is important to note that where the activities of the multinational enterprise entail it being responsible for the work of deputationists [secondees] and the employees continue to be on the payroll of the multinational enterprise or they continue to have their lien on their jobs with the multinational enterprise, a service PE can emerge." In so ruling, the Supreme Court relied on the formal position of MSCo as the legal employer, responsible for paying the salaries, disciplinary action, etc.

Art. 5(2)(l) of the treaty requires that the service be performed "within" India. In this author's view, the formal criterion is perhaps not the most appropriate one for determining whether the formal employer provides a service "within" India. The service under review was the service of putting individuals at MSAS's disposal (after selecting the right individuals upon MSAS's request), running the payroll, sending an invoice to MSAS, exercising the ultimate control, and evaluating the secondees' work. All these elements of the service were performed in the United States, not in India.

On the comparable issue of the lease of industrial, commercial or scientific equipment, Para. 8 of the Commentary on Art. 5 of the OECD Model also takes the position that the mere letting or lease of such equipment does not lead to a PE of the lessor unless the lessor's business is carried on *in* the PE State, i.e. when the personnel in a fully manned charter take business decisions "under the responsibility and control of the lessor". In *Morgan Stanley*, however, this condition was not met so that, projecting Para. 8 of the Commentary into the facts of *Morgan Stanley*, from an OECD perspective, this part of the judgement would have to be rejected.

This view is in line with other OECD developments, such as the interpretation of the term "employer" in Art. 15 of the OECD Model as the substantive employer (as many domestic courts also do). The employer in Art. 15(2)(b) of the OECD Model is the party that is responsible for the day-to-day work, gets the fruits of the employment, has the day-to-day ability to instruct, provides the employees with the necessary tools and place to work, and bears the risk for the work done. This party is, beyond any doubt, MSAS. The OECD would consider this conclusion to be supported if the remuneration paid by the user is calculated on the basis of the time utilized (possibly with a mark-up) and if the qualifications are not determined only by the hirer (Para. 8 of the OECD Commentary on Art. 15 and Revised OECD Discussion Draft on Article 15 of 12 March 2007). This also seems to be the case. All these factors would qualify MSAS as the employer for purposes of Art. 15. It goes without saying that, in cases involving the hiring out of labour, some functions remain with the formal employer (such as payment and other functions pertaining to the legal aspects of the relationship), and this would not negate the OECD conclusion that MSAS was the substantive employer that bore the main responsibilities.

The criterion of responsibility which, by interpretation, may be found to be decisive for purposes of Art. 15(2)(b) of the OECD Model has a direct textual basis in the requirement in Arts. 5(1) and 7(1) to carry on business in the other state. This criterion is to be regarded not only as the place where the work of the enterprise is functionally done (and where not), but also whether the hirer has responsibilities in the work state relating to the work performed. Whether this was the case does not emanate from the contract between MSCo and MSAS. In practice, however, contracts for the hiring out of labour shift the main responsibilities for the employee's acts to the user.

4.2.3.2. Arts. 5(2) and 5(1) of the India–US treaty

As the services paragraph in the India–US treaty is in the list in Art. 5(2), the question arises whether the general criteria in Art. 5(1) should be met or whether Art. 5(2)(l) has an independent meaning, not influenced by the general PE criteria. As the OECD Model does not contain a comparable services paragraph, there is no OECD position on this point. (In the OECD Services Discussion Draft, services are considered a "deemed" PE; thus, the issue does not arise in the OECD context; see Para. 42.23 of the Draft.)

Para. 4 of the Commentary on Art. 5 of the UN Model merely quotes the OECD Commentary without adding a firm confirmation of that view:

> Paragraph 2, which reproduces article 5, paragraph 2, of the OECD Model Convention, singles out several examples of what can be regarded, prima facie, as being permanent establishments .... According to the OECD Commentary, it is assumed that the Contracting States interpret the terms listed "in such a way that

> such places of business constitute permanent establishments only if they meet the requirements of paragraph 1".

Proposed Para. 4 of the UN Commentary reads:[15]

> Paragraph 2, which reproduces Article 5(2) of the OECD Model, lists examples of places that will often constitute a permanent establishment. However, the provision is not self-standing. While paragraph 2 notes that offices, factories, etc are common types of permanent establishments, when one is looking at the operations of a particular enterprise, the requirements of paragraph 1 must also be met. Paragraph 2 therefore simply provides an indication that while a permanent establishment may well exist, it does not prove that one necessarily does exist. This is also the stance of the OECD Commentary, where it is assumed that States interpret the terms listed "in such a way that such places of business constitute permanent establishments only if they meet the requirements of paragraph 1".

Clearly, however, there is tension between the OECD Commentary and the proposed UN Commentary, on the one hand, and the treaty text, on the other, as the treaty text suggests that the places/activities mentioned in Art. 5(2) per se constitute a PE, irrespective of whether the requirements of Art. 5(1) are met. (A proposal is also pending in the United Nations to reflect more clearly in the text of Art. 5(2) of the UN Model itself if, what the Commentary says, is the preferred meaning.)

The unilateral US Technical Explanation of the India–US treaty does not explain the role of Art. 5(1) in relation to Art. 5(2) of the treaty (if we abstract from the rather absolute "will"):

> Paragraph 2 contains a list of fixed places of business (or in the case of subparagraph (l), an activity) which will constitute a permanent establishment. The list is illustrative and nonexclusive. According to subparagraphs (a) through (f) of paragraph 2, the term permanent establishment includes a place of management, a branch, an office, a factory, a workshop, and a mine, quarry or other place of extraction of natural resources. These are all found in the U.S. Model.

The Technical Explanation of the 1996 US Model (not the 1981 US Model, which was the basis of the 1989 treaty with India) does this better:

> Paragraph 2 lists a number of types of fixed places of business that constitute a permanent establishment. This list is illustrative and nonexclusive. According to paragraph 2, the term permanent establishment includes a place of management, a branch, an office, a factory, a workshop, and a mine, oil or gas well, quarry or other place of extraction of natural resources. As indicated in the OECD Commentaries (see paragraphs 4 through 8), a general principle to be observed in determining whether a permanent establishment exists is that the place of business must be "fixed" in the sense that a particular building or physical location is used by the enterprise for the conduct of its business, and that it must be foreseeable that the enterprise's use of this building or other physical location will be more than temporary.

The US Technical Explanation of the India–US treaty, however, seems to regard Art. 5(2)(l) as a fictitious PE. This could *a contrario* be deduced from what is said regarding the US Model: "Under the U.S. Model such activities would constitute a permanent establishment only if they are exercised through a fixed place of business or by a dependent agent."

In India, the position on Art. 5(2)(l) of the treaty was discussed earlier in another AAR ruling (AAR (P. No. 28 of 1999)5). This ruling clarified the meaning of Art. 5(2)(l) of the India–US treaty and stated that, to the extent the general criteria in Art. 5(1) of the treaty influence Art. 5(2)(l), that influence is only of a minor nature and does not mean that the full scope of the requirements in Art. 5(1) are to be met:

> Even assuming that the inclusion clause should be interpreted "against the background" of the general definition contained in paragraph 1 and bears some analogy to it, all that could be said was that sporadic or isolated activities of the kind referred to in clause (1) would not be sufficient to constitute a permanent establishment and that there should be some degree of "continuity" or "durability" and a framework against which the services were rendered. That kind of framework and degree of stability and continuity was present here. It must be held, therefore, that XYZ had a permanent establishment in India within the meaning of clause (1) of article 5(2). (quoted from Para. 8 of the AAR ruling on *Morgan Stanley*)

4.3. Issues under Art. 7 of the India–US treaty

Questions 4 and 5 to be answered by the AAR (Para. 3 of the AAR ruling) were:

> 4. Based on the facts and in the circumstances of the case, even in the event MSAS constitutes a PE of the Applicant in India, as long as MSAS is remunerated for its services at arm's length, whether any further income can be attributed in the hands of the PE of the Applicant?
>
> 5. Based on the facts and in the circumstances of the case, in the event the Applicant is deemed to have a PE in India as a result of sending employees to India or due to deputation of employees to MSAS, whether given the function which would be performed and risks that could be undertaken by such a PE, would a remuneration based on a margin on total operating cost of the PE be the appropriate profit attributable to such a PE?

Question 4 was on the assumption that MSAS, because of its services, constituted a PE of MSCo. Based on the Indian explanation of the treaty, if MSCo was sufficiently remunerated from a transfer pricing perspective, no additional profits were to be attributed to the PE. The AAR ruled: "Circular No. 23 of 1969 ... and Circular No. 5 of 2004 ... are quoted to show that the amount taxable in India would be only that much as is attributable to [the] operations of MSAS. This is too well settled to admit of any elaboration." The AAR was not able to rule on question 5.

Here, however, the Supreme Court gave its view, moving what the AAR said under question 4 to question 5. In Para. 32, the Supreme Court stated (emphasis added):

> Under the impugned ruling delivered by the AAR, remuneration to MSAS was justified by a transfer pricing analysis and, therefore, no further income could be attributed to the PE (MSAS). In other words, the said ruling equates an arm's length analysis (ALA) with attribution of profits. It holds that once a transfer pricing analysis is undertaken, there is no further need to attribute profits to a PE. *The impugned ruling is correct in principle insofar as an associated enterprise, that also constitutes a PE, has been remunerated on an arm's length basis taking into account*

15. The proposed changes to the Commentary were agreed by the Committee of Experts at the 3rd Annual Session along the lines suggested in papers E/C.18/2007/1 and E/C.18/2007/1/Corr.1 for that session, with some minor amendments. For the exact status, see www.un.org/esa/ffd/tax/index.htm.

> *all the risk-taking functions of the enterprise. In such cases nothing further would be left to be attributed to the PE. The situation would be different if the transfer pricing analysis does not adequately reflect the functions performed and the risks assumed by the enterprise.* In such a situation, there would be a need to attribute profits to the PE for those functions/risks that have not been considered.

The Supreme Court used similar language in its conclusion (Para. 33) (emphasis added):

> *As regards attribution of further profits to the PE of MSCo where the transactions between the two are held to be at arm's length, we hold that the ruling is correct in principle provided that an associated enterprise (that also constitutes a PE) is remunerated on [an] arm's length basis taking into account all the risk-taking functions of the multinational enterprise. In such a case nothing further would be left to attribute to the PE. The situation would be different if the transfer pricing analysis does not adequately reflect the functions performed and the risks assumed by the enterprise.* In such a case, there would be [a] need to attribute profits to the PE for those functions/risks that have not been considered.

Assuming that the multinational enterprise could only be MSCo (see also Para. 15 of the Supreme Court's judgement, which equated the multinational enterprise with MSCo), the Supreme Court's conclusion would read:

> As regards attribution of further profits to the PE of MSCo where the transactions between the two are held to be at arm's length, we hold that the ruling is correct in principle provided that an associated enterprise (that also constitutes a PE) (MSAS) is remunerated on an arm's length basis taking into account all the risk-taking functions of the multinational enterprise (MSCo). In such a case nothing further would be left to attribute to the PE. The situation would be different if the transfer pricing analysis does not adequately reflect the functions performed and the risks assumed by the enterprise. In such a case, there would be a need to attribute profits to the PE for those functions/risks that have not been considered.[16]

This approach would connect to the OECD approach as reflected in the Report on the Attribution of Profits to Permanent Establishments discussed above (see 2.2.). Assume, for example, that MSAS's 29% arm's length remuneration would, for 23%, be justified by the tasks performed by MSAS and, for 6%, by the risks incurred by MSCo, taxing the 29% (in the hands of only one party) would reflect the dual taxpayer approach.

In this author's view, the Supreme Court gave a judgement on the allocation of profits to the service PE which is in line with the OECD approach and which is that: to the extent the agent's (MSAS's) assessment properly took into account the risks of the enterprise (MSCo), there was no reason to require the enterprise to report another PE profit.

5. Conclusion

Soon the OECD view on the attribution of profits to PEs will be included in the Commentary on the OECD Model and, as the Commentary is generally not binding on the judiciary, the question arises how domestic courts will deal with the OECD suggestions. In this regard, judgements in other countries may be of influence.

As to the dual taxpayer approach, the courts in India recently gave their view in a number of judgements. The decision in *SET Satellite* clearly confirmed the OECD dual taxpayer approach, but the *Morgan Stanley* decision resulted in a discussion on whether India's Supreme Court supports the OECD. According to the literature on the subject, India's Supreme Court does not.

This article has analysed the *Morgan Stanley* decision and concludes that, contrary to the opinion of others, a close reading of the decision indicates support for the OECD dual taxpayer approach. The article also discussed the differences between the OECD and Indian approaches to testing the requirements of the PE article (often Art. 5) of tax treaties.

16. Para. 32 of the Supreme Court's judgement would then read: "The impugned ruling is correct in principle insofar as an associated enterprise (MSAS), that also constitutes a PE, has been remunerated on an arm's length basis taking into account all the risk-taking functions of the enterprise (MSCo). In such cases nothing further would be left to be attributed to the PE. The situation would be different if the transfer pricing analysis does not adequately reflect the functions performed and the risks assumed by the enterprise (MSCo)."