IMPACT OF THE MORGAN STANLEY DECISION ON THE OUTSOURCING INDUSTRY: UNCERTAINTY OF TAXATION OF MULTINATIONAL ENTERPRISES IN INDIA FURTHER DEEPENED?

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*The ever increasing presence of multi national enterprises (*hereinafter *MNEs) in India coupled with the status of software as a focal area for increase of India's exports, makes the Morgan Stanley decision by the Supreme Court extremely significant. The decision holds far reaching tax implications for outsourcing activities of foreign companies as they are no more required to pay tax on their global income earned from business related to their outsourcing arms/units if these are done at existing market prices. Overall it is a very positive ruling for the business process outsourcing (*hereinafter *BPO) sector. But application of the arms length standard to negate further attribution of profits to a permanent establishment of a foreign enterprise extends the already complex and difficult transfer-pricing rules to the legally and factually distinct situation of the branch, or even to a dependent agent permanent establishment (*hereinafter *PE).*

I. INTRODUCTION

A decision by the Supreme Court of India in July 2007 has established that foreign companies, if conducting business with their outsourcing units at current market prices, would not have to pay tax on their global income earned from such business.[1] This decision is significant from several aspects – from the viewpoint of tax law – raising questions relating to transfer pricing (*hereinafter* TP) and how

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1 Morgan Stanley and Co. Inc. v Director of Income Tax, Mumbai, (2007) 7 SCC 1.

'arm's length price' (*hereinafter* ALP) is to be ascertained; from the standpoint of Business Process Outsourcing (*hereinafter* BPO) units and their future in India, especially the Software Technology Park (*hereinafter* STP) units established under the Software Technology Parks of India (*hereinafter* STPI) Scheme, which is due to expire by the end of the financial year 2008-09.

Software has been declared by the government of India as one of the areas of extreme focus for growth of exports[2] and therefore one of the major initiatives undertaken to create an internationally competitive and hassle-free environment for the information technology (*hereinafter* IT) –IT-enabled services (*hereinafter* ITES) sector has been the establishment of STPs in India in 1991. The STPI is an autonomous non-profit society under the Ministry of Communication and IT of the Government of India. Today, 39 STP centres across India are synonymous with fiscal and non-fiscal incentives and have excellent infrastructural facilities and statutory support in terms of tax exemption, aimed at furthering growth of IT and ITES. Further, India's foreign direct investment (*hereinafter* FDI) Policy permits 100% foreign equity investment in the STP units under the 'Automatic Route' of the Reserve Bank of India.

TP though not a novel concept has attained significance in recent years due to the increasing presence of multi-national companies (*hereinafter* MNCs) in India, facilitated by schemes such as the above, and their ability to allocate profits in different jurisdictions by controlling prices in intra-group transactions. A number of new and complex issues have arisen making it a matter of serious concern for tax authorities. Where two enterprises which are subject to the same centre of direction and control ('associated' enterprises) maintain commercial or financial relations with each other, the possibility exists that, by way of intervention from that centre or otherwise, business conditions must be accepted by the acting units which differ from those which in the same circumstances would have been agreed upon between unrelated parties.[3] The most common way of altering the terms of the transaction is to exert influence on the determination of prices for physical goods, intangible property and services which, as a consequence, may no longer be commensurate with the fair market value;[4] hence the labelling *'transfer pricing'* to this specific field of taxation. In accordance with internationally accepted principles, the TP regulations introduced by the Finance Act 2001, with effect from April 1, 2001 corresponding to the assessment year 2002-2003, require that any income arising from an international transaction or any outgoing like expenses or interest

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2 *See* Department of Information Technology (*hereinafter* IT), Ministry of Communication and IT, Govt. of India, *Software Technology Parks of India*, available at http://www.stpsh.soft.net/Stp.htm (Last visited on February 7, 2009).

3 *See* K. Sonntag & C.S. Mathur, Principles of International Taxation: Model Double Taxation Conventions with an Analysis of India's Tax Treaties and Special Regard to the International Construction Industry 300 (2006). *See generally* OECD TP Guidelines for Multinational Enterprises and Tax Administrations 1999.

4 *Id.*

from the international transaction between associated enterprises[5] shall be computed having regard to the ALP. ALP means the price that would be charged in the transaction if it had been entered into by unrelated parties in similar conditions.[6] The Finance Act 2001 substituted a new section 92 into the Income Tax Act, 1961 and inserted sections 92A to 92F and Rules 10A to 10E which clearly lay down the possible methods of computation of ALP. Often, this ALP is not estimated correctly and MNCs thereby gain enormous profits from manipulating the ALP. Due to this, the countries where these corporations set up their subsidiary units suffer substantial loss of tax revenue. In developing countries, where more reliance is placed on corporate income tax to finance development programs, the fiscal deficit is met by imposing an additional tax burden on the citizens.

Currently, a profit margin in the range of 15-30% calculated on the basis of the sum of the cost, taxes and duties is the regime followed by STP units.[7] On expiry of the 100% tax holiday under Sections 10A and 10B of the Income Tax Act[8] in March 2009, STP units are estimated to pay tax at a rate of 33.99%.[9] Until then, the principle that no one can earn from self does not apply here: a plethora of rulings have clarified that export transactions by Indian STP units to overseas Head Offices should be dealt as transaction between two separate entities and be eligible to deduction under Section 10A of the Act.[10] Budget 2007-08 neither indicated the future of TP regulations in India nor extended the tax holiday under Sections 10A and 10B of the Income tax Act beyond March 31, 2009. Special economic zones (*hereinafter* SEZs), nevertheless, will continue to enjoy tax benefits for five years

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[5] The Income Tax Act, 1961, § 92A provides the meaning of 'associated enterprise'. It means an enterprise:

> "(a) which participates, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise; or
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> (b) in respect of which one or more persons who participate, directly or indirectly, or through one or more intermediaries, in its management or control or capital, are the same persons who participate, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise."

[6] The Income Tax Act, 1961, § 92F(ii): "Arm's length price means a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions."

[7] Morgan Stanley and Co. Inc., *supra* note 1 ¶ 19.

[8] The Income Tax Act, 1961, § 10A(2)(i)(b) gives special provision in respect of newly established industrial undertakings in free trade zones, which explicitly include STPs. Being completely an export-oriented undertaking, section 10B also applies to STPs.

[9] *See* Ishita Russell, *IT Dept. Seeks STPI Sops for 2 More Years*, Business Standard, New Delhi, January 10, 2008.

[10] *See* CIT and Another v. Hyundai Heavy Industries, 2007-TIOL-108-SC-IT; Virage Logic International v Deputy Director of Income Tax, 2007-TIOL-497-ITAT-DEL), Moser Baer India Ltd. and Others v. Additional CIT, 2008-TIOL-476-HC-DEL-IT. *See also* CBDT Circular No. 5 dated September 28, 2004 (Popularly known as 'BPO Circular') (strengthens the separate/distinct entity approach).

more than STPs.[11] Considering the importance of IT-ITES sectors for the continued growth of Indian economy, it has been suggested that the STPI regime "should extend the entire gamut of major direct and indirect tax benefits that the industry genuinely needs, and which are, in some way or the other, addressed in the SEZ scheme."[12] India has several advantages over other developing countries which offer comparable tax incentives for IT-ITES sectors, such as "a vast pool of young English-speaking, technically-competent and cheap manpower, cost competitiveness (through low infrastructure costs and tax incentives) as well as capabilities to move up in the value chain". Despite these, India faces threats on account of rising costs, due to increasing infrastructure and manpower costs and diminishing tax incentives on expiration of the STPI scheme. Due to these factors, the BPO industry in India is likely to suffer a setback. It is in this context that the Supreme Court's verdict is most welcome to STP units.

The Supreme Court's ruling in the Morgan Stanley case[13] indicates that enterprises such as these[14] have a huge incentive to set up establishments in India. As a result of this decision, even if a foreign enterprise has a permanent establishment (*hereinafter* PE) in India, it does not have to pay any more tax on the income attributed to the unit if transactions with the unit are done at ALP. The decision gives a great boost to the outsourcing industry because they are exempted from paying income tax on the transactions carried out by parent companies with subsidiary units in India. This will be discussed in greater detail in the subsequent parts of this note.

The Organization for Economic Co-operation and Development (*hereinafter* OECD) has issued detailed TP guidelines, in an effort to check the manipulation in relation to TP. The OECD guidelines and the UN Model Convention[15] form the basis of the Double Taxation Avoidance Agreement (*hereinafter* DTAA) between India and the US.[16] Also transactions between related parties come under

[11] *See* Suresh Surana, *Budget: Scope for More Lustre*, THE HINDU BUSINESS LINE (Chennai), March 02, 2007, available at http://www.bpoindia.org/columns/budget-2007.shtml (Last visited on February 12, 2009).

[12] *See* Ajay Kumar, Executive Director, PricewaterhouseCoopers as quoted in D. Murali, *Should Software Units Migrate from STP to SEZ?* THE HINDU BUSINESS LINE, May 29, 2006. *See generally* Ernst & Young, *Comparative Analysis: STP Scheme Vis-à-Vis SEZ Act*, available at http://www.isaonline.org/documents/stpi.pdf (Last visited on February 8, 2009).

[13] *See* Morgan Stanley and Co. Inc., *supra* note 1.

[14] Morgan Stanley Advantage Services Pvt Ltd (MSAS) is registered as an STPI. *Mumbai STPI Member List*, available at http://www.stpp.soft.net/datatest.asp?P1=M&P2=N (Last visited on February 10, 2007).

[15] *See* United Nations Model Double Taxation Convention between Developed and Developing Countries 1980 (*hereinafter* UN Model Convention).

[16] *See* Convention Between the Government of the United States of America and the Government of the Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income.

the ambit of Accounting Standard AS 18[17] in India and IAS 24[18] internationally. These standards require disclosure of certain aspects of such transactions. TP regulations are extremely stringent in developed countries such as the United States, the United Kingdom and Australia unlike in developing countries. Regulations were framed in India only as recently as 2001, while Bangladesh, Pakistan, and Nepal are yet to enact legislations. However, multinationals consider India better equipped with TP expertise than many developed nations like the USA, Germany and Japan with documentation work for TP and TP litigation in India assuming enough importance in the last two years.[19]

II. LOCALIZATION IN CONTEXT

The concept of PE was introduced in tax treaties and in domestic tax legislation to ensure that non-resident taxpayers would pay their fair share of tax in any jurisdiction in which they carried on business through a fixed base. Almost all international tax treaties reveal that the presence of a PE is decisive[20] for exercising taxing jurisdiction over unincorporated[21] business activities with economic allegiance to more than one country. The OECD Model Tax Convention on Income and on Capital, 1997 (*hereinafter* OECD MTCIC) defines PE as "a fixed place of business through which the business of an enterprise is wholly or partly carried on."[22] Currently, the international tax principles for attributing profits to a PE are provided in Article 7 of the OECD MTCIC. At first, the PE definition was limited to the existence of a fixed base, but it soon evolved to include other situations, such as the use of a dependent agent or the operation of a construction site.[23] The basic

[17] *See* SANIJV AGARWAL, A MANUAL OF ACCOUNTING STANDARDS 654-659 (2002).

[18] *See* BONHAM ET AL, INTERNATIONAL GAAP 2007 2415-2440 (2006).

[19] *See Indian Tax Authorities Get Kudos from MNCs*, THE HINDU BUSINESS LINE, (Chennai) December 21, 2007.

[20] The foreign enterprise's profits from business activities are taxable by the country where the activities are performed only if the enterprise has a PE there. The OECD Model Tax Convention on Income and on Capital 1997 (OECD MTCIC) Article 7(1), *UN Model Convention* Article 7(1).

[21] *See id.*, Article 5(7).

[22] *See id.*, Article 5(1), also known as the 'basic rule'. The principle that an agent acting on behalf of somebody else may, under certain conditions, constitute a PE for the principal is also well-established today (the 'agency clause'). *See id.*, Article 5(5) and (6); ARVID A. SKAAR, PERMANENT ESTABLISHMENT: EROSION OF A TAX TREATY PRINCIPLE 463 (2008); Landsskatteretten LSR (Danish Administrative Tax Tribunal) November 29, 1982, 1982-3-675, published in MEDDELELSER FRA LANDSSKATTERETTEN 1983-I 40: "to the extent that it is sometimes considered to apply even if the treaty does not have an agency clause."

[23] *See* François Vincent, *TP and Attribution of Income to Permanent Establishments: The Case for Systematic Global Profit Splits (Just Don't Say Formulary Apportionment)*, 53(2) CANADIAN TAX JOURNAL / REVUE FISCALE CANADIENNE, 411 (2005).

nature of a PE may be summed up as commercially separate (in theory atleast) from the HO but still a legally integrated entity of a business enterprise.[24] A subsidiary company on the other hand, is both a commercially and legally separate entity.[25]

It is common knowledge among the authorities and the assessee that the parent and the subsidiary may agree on a price, which is high although difficult to prove inconsistent with the arm's length (*hereinafter* AL) principle. This permits the foreign company to remove a substantial part of the profits from a high-tax source country to a low-tax country of residence. Hence parallel to the objective of fair taxation of foreign enterprises, tax authorities have tried to prevent similar attacks on their tax base via the use of foreign-based non-AL companies and also maintain a level playing field with respect to the use of a branch or a subsidiary to carry on business in a given jurisdiction. The 'authorized OECD approach' urges that it is only sensible to apply the same principle in both situations for which the AL principle was selected by OECD members.[26] The opposite view expresses skepticism regarding both the conceptual foundation and the practical application of the approach as it extends the already complex and difficult TP rules to the legally and factually distinct situation of the branch, or even to a dependent agent PE.[27] It is the first view which has been followed by the Supreme Court in its controversial ruling.

III. BRIEF OVERVIEW OF FACTS

Morgan Stanley Advantage Services (*hereinafter* MSAS) was set up by Morgan Stanley & Co (*hereinafter* MSCo) a US-based investment bank, to provide services such as software development, data processing and back-office operations to the bank. The bank sent staff to India on short-term assignments to perform stewardship functions such as quality control. It also seconded staff to MSAS for longer periods to work under the supervision and control of MSAS. MSCo continued to pay the salaries of the seconded staff and MSAS reimbursed the bank for their costs.

A ruling by the Authority for Advance Ruling confirmed that MSAS did not constitute, under the DTAA, a fixed place of business through which the business of MSCo is conducted. It also confirmed that the presence of MSCo employees in India for a period of over 90 days would trigger the existence of a services PE for MSCo. It was further stated that no part of MSCo's global business would be taxed in India, provided that the Indian PE was compensated at an AL rate.

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24 *See* ARVID A. SKAAR, PERMANENT ESTABLISHMENT: EROSION OF A TAX TREATY PRINCIPLE 1 (2008).

25 *See* Helmut F. Debatin, *Systematik IV,* in Korn/Debatin, 1 DOPPLEBESTEUERUNG, MUNICH (LOOSELEAF) ann. 181. Another point of difference is that a subsidiary is a 'person' under the OECD-based tax treaties, whether it has a fixed place of business or not.

26 *See* OECD, Model Double Taxation Convention on Income and on Capital (Paris: OECD, 1977) and Model Tax Convention on Income and on Capital (Paris: OECD, 1992).

27 *See* Vincent, *supra* note 23.

The income tax authorities appealed arguing that if MSCo has an Indian PE, part of the global income of MSCo should be attributed to that PE and be subject to tax in India over and above the AL consideration paid to MSAS.

The Supreme Court ruling makes clear that the US based entity (*hereinafter* MSCo) has a services PE as a result of employees present in India working through its subsidiary (*hereinafter* MSAS) as the economic employer. The Supreme Court held that MSCo employees acting in the capacity of stewards do not give rise to a PE because the steward's role does not include the conduct of business. The Court's ruling further clarifies that MSAS is not an agent for MSCo within the context of the DTAA; because MSAS has no right to conclude contracts on behalf of MSCo, accordingly there is no agency PE for MSCo in respect of MSCo's investment banking business. The Court also concluded that the nature of services provided by MSAS is ancillary to the investment banking business.

IV. CRITIQUE OF THE JUDGMENT

"While one will need to study the fine print there is a need to appreciate the interplay between attribution of income to PE and application of TP principles. It is relevant to note that as the economic activity of an enterprise gets more complex, the tax exposure from a PE perspective is minimized, but from a TP perspective increases."[28]

The decision has been described as a setback to the revenue department's desire to seek strict source based interpretation for the taxability of non-residents' income.[29] Instead, the Court predominantly relied on interpretation of the UN Model Convention to support AL approach for attribution of profits to PE. If a domestic captive unit of a foreign entity is deemed to be a PE, it gives the income-tax department the right to lay a tax claim on the profits of the foreign entity that can be traced back to its captive unit. The review petition being rejected by the Apex Court in January 2008, the government cannot lay a claim to anything beyond ALP relationship between the two.[30] While there is no dispute as regards calculation of the ALP on which the TP methodology is based, the controversy is whether an AL relationship (between the foreign entity and the domestic captive unit) can absolve a foreign entity from potential PE exposure.

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[28] Samir Gandhi, Partner, Deloitte, Haskins & Sells in Mumbai as quoted in Ralph Cunningham, *Morgan Stanley comes out on top*, INTERNATIONAL TAX REVIEW, July 12, 2007, available at http: //www.internationaltaxreview.com/default.asp?Page=9&PUBid= 210&ISS=23959&SID=689609 (Last visited on January 31, 2008).

[29] Mukesh Butani, Chairman of the Tax and Tariff Committee of the American Chamber of Commerce, as quoted in *Morgan Stanley Comes Out on Top*, *id*.

[30] Ketan Dalal, Executive Director, PricewaterhouseCoopers as quoted in Sanjiv Shankaran and Malathi Nayak, *Foreign Firms' Indian Units Can Take It Easy*, available at http:// www.livemint.com/Articles/2008/01/24232315/Foreign-firms8217-Indian-un.html (Last visited on February 13, 2008).

An attempt to discuss the correctness of applying of TP principles for attribution of income to the PE requires examination of the two subjects—TP under article 9 of the OECD and attribution of profits under article 7—as part of the larger question of how the profits of a MNE should be taxed by the jurisdictions in which it carries on business. As far as the present authors are concerned, this argument discourages an attempt to give either a full representation of all provisions specific to PE or the policy underlying the principle of TP because of two reasons: first, as the themes have been extensively dealt with previously[31] and second, as the application of the Apex Court's analogy of applying the AL standard for attribution of income to PE poses difficulties as elaborated below.

The Court's analysis of the nature of services performed by MSAS and conclusion that these services are ancillary to the investment banking business appears to follow the reasoning that if there is no agent, there can be no dependent agent; hence the analysis was more *in the context of its conclusion that when an AL consideration is established* after taking into account all the risks and functions of the MNE, nothing further can be attributed to the PE.[32] The Court here appears to be proceeding on the misplaced assumption that the crux of the test of presence of PE is neither the basic rule nor the agency clause[33] but whether the TP *methodology* can be challenged based on the tax authorities' interpretation of the risks and functions undertaken by the MNE. Further, the principle of AL is applicable only when the transaction is between associated enterprises and not between an enterprise and an unrelated party.

The topic of attribution of profits has been on the OECD agenda for more than 6 years. The OECD project[34] whose ultimate goal was to extend the TP guidelines developed in connection with Article 9 of the UN Model Convention to the circumstance of a PE was completed in July 2008 with the release of the Final Report. The discussion draft on a revised Commentary concerning Article 7 (Business profits) of the OECD Model Tax Convention issued on 10 April 2007 was the first of the last steps of the OECD in developing an authorised OECD approach to the attribution of profits to PEs. The lack of a common interpretation and consistent application of Article 7 can lead to double, or less than single, taxation. The Final Report released in July 2008 concludes that the AL principle is at the heart of Article 7.[35] Hence the authorized OECD approach is to apply the AL principle of Article 9,

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[31] *See* Brian E. Lebowitz, *TP and the End of International Taxation* 19 (13) TAX NOTES INTERNATIONAL 1207-10 (1999); Michael C. Durst; Robert E. Culbertson, *Clearing Away the Sand: Retrospective and Prospective Documentation in TP Today* 57(1) TAX LAW REVIEW 37-135 (2003) and MUKESH BUTANI, TP: AN INDIAN PERSPECTIVE (2007).

[32] *See* Shiv Kapoor, *Commentary: Morgan Stanley Case Answers the Big Question, But Leaves Others Unanswered*, INTERNATIONAL TP JOURNAL November-December 2007, 354.

[33] *See* Helmut F. Debatin, *OECD- Empfehlungen zur Vermeidung internationaler Doppelbesteuerung*, RECHT DER INTERNATIONALEN WIRTSCHAFT 374-382 (1978), 379. *See supra* note 21.

[34] *See* OECD, Discussion Draft on the Attribution of Profits to Permanent Establishment: Part I (General Considerations) (Paris, OECD, August 2004).

[35] *See* OECD, Report on the Attribution of Profits to Permanent Establishments, July 17 2008.

as articulated in the Guidelines, to the attribution of profit to a PE using the AL principle under Article 7(2). One admitted purpose of the OECD project, as reflected in the Report, is to capture what are perceived to be the vanishing profits of MNEs in situations where a local presence may not constitute a “dependent agent” within the meaning of Article 5. There are, as mentioned in part two of the note, two opposing views on this question. The taxpayers insist that it all rests on getting the TP methodology right. If there is a dependent agent PE, and if the PE assumes significant risks or performs valuable functions, then article 9 and the TP guidelines can capture the profit. Tax authorities would however be unconvinced of the theoretical soundness of this argument and, probably more important, worried about its practical effects as they conceive that there are two distinct profits to be taxed, that of the agent and that of the principal.

The Report notes that the aim of the authorized OECD approach is not to achieve equality of outcome between a PE and a subsidiary in terms of profits, as there are generally economic differences between using either of them. Rather, the aim is to apply to dealings among separate parts of a single enterprise the same TP principles that apply to transactions between associated enterprises. According to the Report, the economic effects of the legal form chosen, PE or subsidiary, should be reflected in the determination of taxable profits. In many cases, businesses operate through permanent establishments rather than separate entities precisely because the PE structure provides for efficient capital utilization, risk diversification, economies of scale, etc., making the structure more profitable. Thus, a PE will be more commonly used in some sectors (banking, insurance) or for activities carried on temporarily in a State (public works) or by virtue of the level of activity or complexity of operations. By contrast, a subsidiary may combine a more complete set of operations within a country.

Article 9 permits a State to tax an enterprise on profits that would have accrued to it but that have not so accrued because the conditions imposed in its financial or commercial dealings with an associated enterprise differ from those that would be made between independent enterprises.[36] The article thus contemplates that the calculation be made under an assumption contrary to facts. The ‘functionally separate entity’ theory that anchors the authorized OECD approach is derived from article 7, paragraph 2[37] of the UN Model Convention. Under this approach, paragraph 1 of Article 7 is interpreted as not affecting the determination of the quantum of the profits that are to be attributed to the PE, other than providing specific confirmation

[36] *See* OECD MTCIC Article 9.

[37] Article 7, *id*: “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 conditions are made or imposed between that enterprise and the agent in their commercial and financial relations which differ from those which would have been made between independent enterprises, he will not be considered an agent of an independent status within the meaning of this paragraph.”

that, "the right to tax [of the host country] does not extend to profits that the enterprise may derive from that State otherwise than through the permanent establishment", i.e. there is no 'force of attraction' resulting from the existence of a PE.[38] Article 7, paragraph 2 attributes to a PE the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.[39] This provision superposes two hypotheses:[40] (1) that the PE is a distinct and separate entity engaged in the business carried on by the PE under the same or similar conditions, and (2) that this notional entity deals independently with the enterprise of which the PE is a part. The authorized OECD approach effectively combines the hypotheses of articles 7 and 9. The hypothetical separate enterprise is supplied with hypothetical functions, assets, risks, and capital. Thus the methodology appears to balance unsteadily on this first construction the considerable weight of the TP guidelines established under article 9, applied to 'dealings' between the PE and the enterprise of which it is a part that are meant to be the analogue of real transactions.

The conclusions in the Report are to be reflected in a new version of Article 7, and a new Commentary on that Article, to be used in the negotiation of future treaties and of amendments to existing treaties. The Committee on Fiscal Affairs intends to include that new version of Article 7 and its accompanying Commentary in the next update to the OECD Model Tax Convention (currently scheduled for 2010). It must be noted that the current standards under Article 5 for determining the existence of a PE are unaffected by the Report.

V. CONCLUDING REMARKS

It was hoped by tax experts, MNEs and tax authorities that the Supreme Court's verdict would resolve the long-standing debate over the taxability of the MNE's operations in India, but unfortunately it has only served to deepen the confusion. However, the position has become more intelligible after the appeal in *SET Satellite (Singapore) Pvt. Ltd.*[41] was scrutinized seven months after the *Morgan Stanley* verdict. The exact issue in *Morgan Stanley* was raised in the case[42] and the order of the Income Tax Appellate Tribunal (*hereinafter* ITAT) dated

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[38] *See* OECD, *supra* note 34.

[39] *See* OECD, Revised Commentary on Article 7 of the OECD Model Tax Convention (Paris, OECD, April 2007). Paragraph 11 of the Commentary on Article 7 indicates that this language "corresponds to the 'arm's length principle' discussed in the Commentary on Article 9."

[40] *See* Robert Couzin, *Taxation and Its Impact on Market Structure: Comment, in* TAXATION TO 2000 AND BEYOND 257-262 (2002).

[41] *See* SET Satellite (Singapore) Pte Ltd., a Company incorporated and registered under the laws of Singapore v. Deputy Director of Income-tax International Taxation, Rg.2(1) and Director of Income-tax, International Taxation, (2008) 218 CTR (Bom) 452.

[42] *Id.* ¶ 9 (whether a non-resident carrying on business in India through a dependent agent, who was remunerated on an AL basis, and has no permanent establishment in India was liable to tax in India with respect to income derived from advertisement or marketing in India).

April 2007 to tax back-office operations even if the parent company had paid its Indian agent at ALP had been in direct contravention of the Supreme Court verdict. The Bombay High Court overruled the same on the basis of the *ratio decidendi* in *Morgan Stanley*[43] to hold that if correct ALP is applied and paid then nothing further would be left to be taxed in hands of the foreign enterprise. Thus in matters of tax what has to be considered and more so in International transactions if there be a treaty, the provisions of the treaty and if the provisions of the treaty are more advantageous to an assessee, then the construction will have to be given which is advantageous to the assessee. Even if the legality of the *Morgan Stanley* decision is accepted as certain, the tax stability of MNEs will be in question as tax authorities will exercise the only option to increment revenue from tax: by aggressively challenging TP methodology on the risks and functions undertaken by the MNE. With the global market for software outsourcing becoming tougher and China eyeing the top slot, the sooner the taxation of MNEs is resolved, the greater will be the viability of the innumerable BPO units in India.

[43] *Id.* ¶ 13 (income of non-resident, carrying on business in India, through dependent agent, remunerated at AL, and not having permanent establishment in India cannot be liable to tax unless such income is directly nor indirectly attributable to that of the permanent establishment).