BEFORE THE HON'BLE HIGH COURT OF KARNATAKA

AT BENGALURU

WP No. 50000 of 2024 & WP No. 50001 of 2024

Southern Operating Systems India Pvt. Ltd
Bengaluru ***… Petitioner***

vs.

Additional Commissioner of GST and Others
Bengaluru ***… Respondents***

1. Southern Operating Systems India Pvt Ltd (SOS or the Indian Company) is a company registered under the Companies Act, 1956 having its registered office in Bengaluru. The company was incorporated on 01.04.2010 which is almost a 100% subsidiary of a US company namely, Southern Operating Systems Inc., (SOS US or the US Company) incorporated in Delaware, the US many decades ago. Both the companies are into manufacture of novel software products and are one of the global leaders in software development in niche areas. The Indian company was set up to tap the potential of the software market in India and Asia Pacific and to make the Indian company equivalent to the US company in software development and value addition to their customers worldwide.

2. The US company was already well established in software development and related research and development by the time the Indian company was set up. When the Indian company was to be set up, the key managerial persons (KMP) were sent to India in 2010 to set up the Indian company so that there would be transfer of technological know-how, expertise and to maintain the quality of the products manufactured. Around two dozen very highly paid senior KMPs from the US had arrived in India to set up the Indian company. The salaries paid to these personnel were ridiculously high mainly due to the stock option schemes and perquisites given in kind. Therefore, the US company, as a cost center and for prudent accounting purposes, decided that only if these employees work for the parent US company, the US company should bear their salary expenses. If and when they were sent to any offshore group company, for example like SOS India, it was decided that such host company

like SOS India should incur the salary and other expenses of these personnel who are seconded to such host companies. There was also a 'secondment agreement' to this effect between the home country company and the host country company in each situation.

3. The US company sent its KMPs to set up and commence the operations in India covering India and the Asia Pacific region. Since the Indian company was just set up and since the income, far less, the profits of the company would only be generated after initial few gestational years, it was thought apropos by the US company that it would absorb the salary and other emoluments expenses of the KMPs in the initial years until the Indian company was in a position to bear the salary and other expenses of such personnel. Therefore, even though the KMPs were involved in setting up the Indian company and were physically present only in India, they were paid their salaries, etc. in the US as usual in their regular US salary accounts.

4. After the Indian company was set up, the KMPs brought their expertise and know-how to the niche software technology which was otherwise only importable into India from the US. Their presence was a significant contribution to the ever-evolving Indian software industry and to the Indian economy as a whole. Within two years of the commencement of business, the Indian company started to make significant revenue which also resulted in substantial profits. The revenue generated was sufficient to absorb the salary costs of the KMPs among other things. So, from the third accounting year onwards i.e. 01.04.2012, the Indian company reimbursed to the US company, on actual basis, the salaries paid to the KMPs in cash and kind in the US. It was also decided that the Indian company had to reimburse the salaries paid to the KMPs for the first two years also so that it takes care of all the salary expenses from its inception.

5. For all legal purposes, the US expats (seconded employees to India) were treated as employees of the US company. However, for all economic purposes, the Indian company was treated as the employer of the expats. Meaning, though the termination of the employees from service was with the US company, the termination of the secondment arrangement with a particular employee was with the Indian company.

6. Under such circumstances, in May 2017, the Indian company received show cause notices (SCN) from the service tax department for the period from April 2012 to March 2017 that as to why the Indian company should not be held liable to pay service tax under reverse charge

mechanism (RCM) for importing services from its US parent company under the service category 'Manpower Supply Services', etc. to have seconded certain employees from the US to India. SOS India staunchly denied its tax liability as it primarily argued that the reimbursement of the salary expenses was only on cost-to-cost basis without any markup to the US company and hence this was not a separate commercial activity of the US company but more of its core business activity which was 'in relation to' software development. The next argument was that 'taxable service' under the Finance Act, 1994 (legislating service tax law) did not include employer-employee relationship and since the Indian company became the economic employer of the expats after the secondment, the supply of manpower (expats) by the US entity should not be seen as an on-going commercial activity and the US company had lost control over its own employees since the employees have for all practical purposes become the employees of the Indian company. The Indian company argued that though there was secondment of employees, it should be seen as 'contract of service' between the Indian company and the expats and not as 'contract for service' between them as per the principles of contract laws and thereby falling under the exemption and thus challenged the show cause notices before the Hon'ble High Court of Karnataka in 2017.

7. The Karnataka High Court held that the Indian company was liable to pay service tax under RCM for import of services (IOS) since the supply of seconded employees by the US company to the Indian company was to be treated as manpower supply services even though there was no markup to the US company as profit element was not necessary for imposing service tax. However, the High Court quashed the notices to the extent they were issued pertaining to the extended period of limitation under the Finance Act, 1994 as according to the Court, the non-payment of service tax by the Indian company was not attributable to any of the exceptions for applying the extended period of limitation. Since it was a well-reasoned order, the Indian company accepted the order and paid the service tax to the applicable periods.

8. In July 2017, the Goods and Services Tax Act, 2017 (GST Act) was introduced w.e.f. 01.07.2017. As per section 7 read with Schedule III to the Act, 'services by an employee to the employer in the course of or in relation to his employment' was treated neither as a supply of goods nor a supply of services. This was similar to the relevant provisions in the Finance Act, 1994. In 2022, the Hon'ble Supreme Court of India in a similar case under the service tax regime held that the Indian company would be liable to pay service tax for secondment of employees as import of services even if the parent company had not earned

any profits. This made the Indian company to rethink its secondment strategy as several highly skilled employees were being seconded to India in large numbers on routine basis by the parent company and other group companies located in various countries having significant and unnecessary GST implications.

9. The Indian company wanted to somehow wriggle out of the clutches of the implication of GST since the Supreme Court had settled the law in favour of the revenue albeit under the erstwhile regime. Though the judgement was in the context of erstwhile service tax regime, the Indian company felt that it will face similar fate if it continued with the same structure with regard to secondment of employees given the aggressive stand of the GST department. Therefore, as a tax planning measure, the Indian company and the US company keeping the expats in confidence, decided to terminate the services of all the expats sent to India from the payrolls of the US company and planned to induct them in the Indian company's payrolls. The terms of new employment were such that the expats, for all legal and other purposes, will be treated as employees of the Indian company not just from the date of issue of the new appointment letter by the Indian company in June 2022 but from the date these expats were seconded to India in 2010 thereby making the expats the employees of the Indian company throughout the 12 years' period as they were physically staying in India while rendering the services.

10. It was thought that by this arrangement, the employees will benefit from the Indian employment laws like the gratuity, employees' insurance, etc. and more specifically, the group of companies as a whole felt that there would be no GST implication post 01.07.2017 since the services rendered by the employees of an Indian company to an Indian company will not be liable to GST and the US company cannot be treated as supplier of manpower as the employees are no more under the legal control of the US company as they were under the erstwhile service tax regime. So, all the expats were provided termination letters by the US company in June 2022 and new appointment letters were issued by the Indian company simultaneously. This arrangement was intended to avoid GST from 01.07.2017 to 31.05.2022.

11. The Indian company went ahead in tax planning and from 01.06.2022 whenever it wanted secondment of employees from the US or other group companies, it did not second them like before. Instead, it made an arrangement that any expat who had to be seconded to India will be terminated from the services of the seconding company (home company) and will be freshly appointed in the Indian secondee company (host company). By this, the Indian

company felt that the issue of manpower supply has been taken care of since such employees are no more under any contract of service with the US company which was sine qua non for taxing under this category but would rather only be treated as fresh recruits by the Indian company. It was further felt that since no reimbursement of salary is being made by the Indian company to US company under this arrangement, there can be no 'valuation' issues to impose GST. The salary in India was based on the salary that was paid to such expats in the US. Usually, the secondments were for a duration of at least five years.

12. Under such circumstances, the GST department issued two show cause notices on 31.01.2024 to the Indian company to show cause as to why GST should not be imposed on the secondment arrangement between the US company and the Indian company up to 31.05.2022 and the second SCN was issued for the period from 01.06.2022 to 31.12.2023 which questioned the 'innovative arrangement' of the Indian company which in a way poached the employees from the US, etc. companies as its own employees which in effect was also import of services from the foreign group companies to have arranged/ identified such employees. The SCNs mentioned that since the Indian company had accepted its tax liability under the service tax regime for the very same arrangement until GST Act was introduced, not paying GST for the same arrangement is willful and with the intention to evade tax and therefore, the extended period, as may be applicable, was invoked with imposition of maximum penalty. For the purpose of valuation, the department treated the service provided by the US company as an on-going service in providing such employees to the Indian counterpart and therefore, their salaries should be treated as the 'deemed consideration' for determining tax liability.

13. The Indian company immediately responded to the SCNs vehemently contending that the SCNs were absolutely without jurisdiction as no GST was payable on such arrangements. The Indian company countered the SCNs on the lines that for the period from 01.07.2017 to 31.05.2022, the employees were terminated from the services of the US company and were handed over with fresh employment letters by the Indian company under its payrolls. Further, the experience letters issued under the letterhead of the Indian company stated that the period of employment from 2010 till 31.05.2022 will be treated as employment only with the Indian company due to their complete devotion towards the Indian company during this period. Therefore, for this period the services rendered by the employees were not as expats but purely as the employees of the Indian company which was specifically neither treated as supply of goods nor services under section 7 read with Schedule III of the GST Act, 2017.

Regarding the period from June 2022 onwards, the Indian company replied that since the expats were recruited in the Indian company even before they could be seconded unlike the hitherto arrangement, there was no question of treating this as manpower supply services by the US company as there was only direct payment of salary to such foreign employees in India without any reimbursement arrangement. It was argued that in both cases there was complete localization of the expats to India.

14. The GST department did not accept the replies to both the SCNs and confirmed the demand in March 2024 by relying on the definition of 'services' and Schedule I to the GST Act read with section 7 to hold that since the supply of manpower was neither goods, money nor securities, it would fall within the definition of 'services' and there was no need for any flow of consideration in case of import of services by a person from a related entity which was used in the course or furtherance of business of the Indian company. Holding thus, it confirmed the demands of huge amounts and also confirmed the penalty as applicable since the assessee contested the demands more particularly because the Indian company wantonly did not pay the taxes even though for similar transactions it had paid service tax previously. The department also invoked the extended period of limitation as applicable to the case.

15. Against the demand orders, the Indian company filed two writ petitions before the High Court of Karnataka. The broad issues before the Court to be addressed and considered were:
    i. Whether the writ petition is maintainable.
    ii. Whether the department had jurisdiction to issue the SCNs if the services were not liable to GST *per se*.
    iii. Whether secondment arrangement in general liable to GST.
    iv. Whether based on the experience letters issued for the period from 2010 to 2022, it can be said that there will be no GST implication for this period.
    v. Whether based on the arrangement from 01.06.2022, it can be said that there will be no GST implication.
    vi. Whether there is any import of services under GST and whether the Indian company is liable to pay GST under reverse charge mechanism.
    vii. Such other issues as may be relevant.

16. Since the stand of the department was of significant importance to thousands of Indian companies who second expats from their group companies abroad, the case was eagerly observed by the associations of various sectors.