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Client Alert

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New Guidance from the Indian Revenue Authorities Raises Important Tax Issues for Indian Outsourcing Transactions

In a recent Circular issued by the Office of the Indian Minister of Finance,[1] the Indian Revenue Authority provides important guidance that indicates when outsourcings to Indian vendors may create Indian income tax liabilities for a non-Indian outsourcing company. The Circular confirms that such outsourcings will normally not create Indian income tax obligations where the outsourcing company (the "Customer") has no permanent establishment (PE) in India, but raises the possibility that certain outsourcing transactions – notably those involving core revenue generating functions of the Customer– could create significant Indian income tax liability where the Customer has an Indian PE. Moreover, the Circular appears to adopt a new standard that would subject more income to Indian income taxation than might otherwise be expected where a Customer outsources a core function to India. Thus, it is very important for Customers that outsource to India to carefully assess whether the Circular will increase the cost of the outsourcing.

Key Provisions of the Circular

The Circular notes that outsourcing transactions from non-resident Indian companies to Indian vendors have raised a number of important Indian income tax issues. Chief among them are whether an outsourcing to an Indian vendor justifies Indian taxation of a portion of the Customer's global profits. In this context, the Circular discusses two general categories of outsourcings. The first involves outsourcings of so-called "incidental" activities of the Customer. While it is not entirely clear, incidental activities are those activities that are not "core" revenue generating activities of an enterprise. Specific examples of incidental activities discussed in the Circular include the establishment by a computer manufacturer of a call center in India to procure orders from or conclude contracts with customers abroad and to answer sales related queries over the phone. A call center set up by a non-Indian insurance company to handle calls from customers outside India regarding the acquisition of new policies or revisions to existing policies, or to disseminate information to customers would also be an incidental activity. In that case, actual policy issuance and collection of premiums would be considered a "core revenue generating activity" and not an incidental activity.

Under the Circular, the so-called incidental activity conducted by the Indian vendor would not result in a direct Indian income tax liability for the Customer even if the Indian vendor's activities would otherwise create a PE for the Customer under a relevant income tax treaty.[2] Thus, presumably the Customer would have no substantive Indian income tax liability nor would it have a tax return filing obligation.

However, if the Indian vendor did not receive arm's length compensation for its services, the Customer would not be entitled to this relief under the Circular, and would presumably be subject to tax on the portion of its profits that are attributable to the activities of the Indian vendor.[3]

The Circular also does not address the outsourcing of incidental activities by a Customer that cannot claim benefits under an income tax treaty. Presumably, the Customer could not claim any relief under the Circular when it outsources incidental activities to an Indian vendor. This omission raises serious questions for companies resident in treaty jurisdictions that have subsidiaries that are resident in non-treaty countries that also outsource to Indian vendors. Those subsidiaries have no standing to claim benefits under an income tax treaty that may cover the parent. Thus, it is possible that outsourcings by such subsidiary companies could result in Indian tax liability even though a similar outsourcing would not raise tax issues for its parent.

The second type of transaction covered by the Circular involves outsourcings of "core revenue generating business activities." The Circular specifically lists outsourcings by companies in the travel agency, software development, software maintenance, investment consulting, and debt collection businesses as potentially involving activities that are likely to be treated as involving delegations of core revenue generating activities.

Presumably, this is because the functions outsourced to Indian vendors by these types of businesses involve the essential services that attract clients to those businesses, though the definition of a revenue generating activity remains very unclear under the Circular. The key difference in the treatment of such "core activities" under the Circular is that a "considerable portion of the profits derived by the nonresident … from its customers abroad would certainly be attributable to the activities performed" by the Indian vendor. Where the Indian vendor also constitutes a PE of the outsourcing company, the Circular makes clear that such an outsourcing would create Indian income tax liability for the Customer.[4] Consequently, an Indian income tax liability could exist even if the vendor is being paid an arm's length fee. Thus, what

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otherwise appears to be a commercially valid market transaction could be subject to recharacterization for Indian tax purposes in order to bring profits outside of India into the Indian tax net. In addition, it is unclear just how much income is a "considerable portion," and thus it is difficult to quantify or estimate with any accuracy the potential exposure that results from outsourcing a core revenue generating function.

If other jurisdictions do not respect this allocation of profit by the Indian tax authorities, they too may assert tax jurisdiction over the profits taxed in India under the Circular, potentially resulting in double taxation. Obviously, such double tax could add significant costs to the outsourcing. Affected taxpayers could seek redress under the double tax provisions of a relevant income tax treaty but such relief may take a long time to obtain and the outcomes of such proceedings are never certain.

Companies should carefully assess the implications of the Circular on their current and potential outsourcing transactions. The uncertainty over what constitutes a core revenue generating function creates significant tax risks for outsourcings involving functions that contribute significantly to a company's sales. While the Circular does not address the point, it may be possible to obtain a ruling from the Indian tax authorities concerning whether a contemplated outsourcing creates tax liabilities for the Customer. Also, companies that can take advantage of a relevant income tax treaty should make sure (to the extent possible) that an outsourcing to an Indian vendor does not create a PE.

However, this will not always be a simple task because of the expansive PE definitions contained in some Indian tax treaties. For example, the US-India tax treaty (the Treaty) states that a dependent agent[5] that has authority to conclude contracts on behalf of a non-resident may constitute a PE of the non-resident principal if the dependent agent regularly exercises such authority. In fact, the Treaty specifically provides that a PE arises where an agent regularly secures orders on a regular basis for a non-resident US principal and the bulk of the agent's business activities are performed for the principal.[6] Thus, a US computer manufacturer that sets up a call center in India with a dependent agent to take purchase orders could have a PE under the Treaty[7] unless it can show that the agent performs a significant amount of work for other clients. Obviously, due diligence should be done to determine whether or not an Indian vendor will be a dependent agent.

In sum, the Circular raises a number of tax issues that may make the tax consequences of an Indian outsourcing more difficult to assess. Clearly, companies should keep it closely in mind when structuring their transaction to determine whether they have potential Indian exposure and they should include appropriate tax analysis in their financial evaluation of the transaction.

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[1] Circular No. 1/2004.

[2] Under provisions of the US-India income tax treaty, a call center of the type discussed in the text could create an Indian PE. As a result, India would have the right to tax the Customer on the Customer's profits that are attributable to such PE.

[3] It is not clear under the Circular how much of the Customer's income would be subject to tax in India in this situation. Presumably, the Indian government would allocate an amount that taken together with the amount received by the Indian vendor would constitute an arm's length compensation. The Circular also does not address the outsourcing of incidental activities by a non-Indian company that cannot claim benefits under an income tax treaty. Presumably, such a company could not claim any relief under the Circular.

[4] If the vendor is not a PE, then the outsourcing company would not be subject to tax provided the company claimed benefits under the PE article of a relevant treaty.

[5] A dependent agent is a person who is legally or economically dependent on its principal. This would cover an agent that either (1) derives most, if not all, of its business from a single principal (economic dependence) or (2) is bound to take directions regarding its day to day operations from its principal (legal dependence).

[6] See paragraph 4(c), Article 5 of the Treaty. The provision of services in India by a US company may create a PE in India if the services are provided for a period of 90 days within a 12 month period or the services are provided to a related entity. See paragraph 2(l), Article 5 of the Treaty. This is true even if the company otherwise has no fixed place of business in India. Thus, *US* vendors that provide services in India could be caught by the Circular because the provision of such services would create a PE under the Treaty and would likely be viewed as a core revenue activity under the Circular.

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