Client Alert

Global Sourcing | India

March 7, 2011

India Moves to Tax the Foreign Income of Its Outsourcers—End of the Offshore 'Vacation'?

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On February 28, 2011, the new Indian Union Budget was presented to the Indian Parliament.[1] Although the budget includes numerous changes relevant to businesses operating in India, certain tax-related provisions are particularly salient to the customers of Indian outsourcing providers.

Key Changes to the Indian Tax Laws for Outsource Providers

The Indian Minimum Alternative Tax (or "MAT," which is similar in nature the U.S. construct of Alternative Minimum Tax or AMT) has been made applicable to businesses operating in India's SEZs or "Special Economic Zones." In addition, the rate of the MAT has been increased from 18% to 18.5%. These changes will be applicable beginning in April 2012.

Even more interesting than what was included in the new budget, however, may be what was not included. Specifically, the Software Technology Parks of India (STPI) scheme, which allows income on exports from registered companies to be excluded from taxation, was already scheduled to expire in March 2011.[2] Many in the IT and outsourcing industry had believed that this expiration would be extended for at least an additional year (perhaps to coincide with the elimination of the MAT tax holiday in the SEZs). However, no such extension has been granted, meaning that the STPI scheme will expire at the end of this month.

Because most offshore providers have historically taken advantage of the STPI scheme and have located in SEZs, the combined result of these changes is that, for the 2011 tax year, the income of offshore providers from business outside of India (e.g., in the United States and the United Kingdom) that was previously not subject to income tax will be subject to the applicable tax regimes. Beginning with the 2012 tax year, the MAT will apply to those income streams—even for providers in SEZs—meaning that the minimum amount of the income tax will be 18.5%.

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1 Finance Bill, 2011 was presented by the Honorable Finance Minister, on February 28, 2011 in the lower house of the Parliament. This synopsis describes certain important features of the Bill announced therein as relevant to offshore providers, however neither Luthra & Luthra Law Offices nor Pillsbury claims that the amendments discussed herein are exhaustive.

2 In certain circumstances, the STPI benefits for some providers may have already expired, so the impact of this change will not be uniform across all providers.

Implications for Customers of Affected Providers

In light of these changes, which will necessarily increase the cost of providing offshore services from India, most existing customers of outsourcing services are probably thankful that they have existing agreements and that their pricing is fixed. However, customers would be well-advised to review carefully the tax provisions of their agreements. In some cases, that language may require the customer to share, or even bear entirely, the brunt of tax changes. In addition, even where the customer has protection from changes in tax laws, it is possible the provider may be able to recover this cost through cost-of-living adjustments (depending on the metric selected) or in renewal pricing negotiations.

Particularly in the early days of offshoring, certain Indian providers were quite focused on the tax holidays they were enjoying, and were therefore also focused on protecting their downside risk of this tax holiday going away. While this may at first blush appear to be “wrong” to a customer, it is in fact a real cost of taking advantage of the benefits of business in India and there is likely no single right or wrong allocation of this risk.

For new customers of outsourcing services, we recommend having a clear and open discussion of the tax situation with the provider in connection with negotiation of pricing. Because the two changes discussed above will happen over time, the pricing should take into account both changes (to the extent applicable), and the customer should be certain to obtain protection relating to these changes.[3] Unlike for existing customers where this change in tax law was arguably an unknown (albeit foreseeable) risk, the change is clearly known at this point, and there is no reason not to factor it into the pricing model.

Note that the ultimate implication of these changes is to eat into the labor arbitrage savings that have been enjoyed by the Indian offshore provider community. This does not mean that Indian offshore providers are necessarily going to be more expensive, but it does force them to become more competitive on a global basis. For example, a new burden of 18.5% could readily turn the economics of an offshore transaction on its head. Even if labor rates remain lower than in the U.S., certain India-based transactions may become less competitive with other offshore destinations such as the Philippines.

For further information or questions regarding if and how these changes may affect your existing agreements or your ongoing negotiations, please contact:

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[3] It may be reasonable to have the supplier “smooth” the impact of the changes so that the customer does not experience a large pricing increase, but this is better factored in after the customer has had visibility into the tax implications.

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