# Business Process Outsourcing:
# Business, Legal and Tax Issues

**Vaibhav Parikh and Shagoofa Khan**
Nishith Desai Associates

## Introduction

Business process outsourcing is *"the act of transferring some of an organization's recurring internal activities and decision rights to outside providers, as set forth in a contract."*[1] Gartner Dataquest defines the BPO as "delegation of one or more IT intensive business processes to an external provider that, in turn, owns, administers and manages the selected process(es) based upon defined and measurable performance metrics." Thus, BPO involves relinquishing responsibilities and authority related to the design, development, implementation, and operations of an outsourced business process - including operational decision-making, hiring people, building facilities, acquiring and maintaining equipment, and upgrading technologies - associated with the process. Organizations decide to outsource business processes for various reasons such as for improving competitiveness, to increase focus on core competencies, to access relevant skills and expertise, to serve larger markets, reduce costs.

In recent years, organizations increasingly have been trying to outsource non-core processes for various reasons. Outsourcing initially started with the outsourcing of some primary processes, but now involves outsourcing of an equal portion of secondary activities. The major activities currently outsourced are Payroll, Recruitment, Employee training and development, Retirement plan administration, Information systems development, Information technology infrastructure, Customer call centers, Travel reservations, Technical support centers, Billing, Claims processing, Inbound and outbound logistics, Warehousing and inventory management, Document processing, Accounts payable/receivable, Auditing, Tax document preparation, Facilities maintenance, Medical transcription, Contract research, Legal documentation and Information processing. Even in government services, outsourcing is becoming common. New York city has outsourced its parking ticket processes.

## Strategies for Offshore Outsourcing

Despite compelling economic reasons, companies may still be reluctant to outsource all of their operations to a foreign country due to concerns about security, delivery, and enforceability of agreements, among other concerns. Such risks can be minimized by:

- Setting up captive centers in the offshore jurisdictions, as this would address their concerns of non-delivery of services and enforceability of agreements
- Outsourcing their low-end services to a foreign company, and then outsourcing higher-end work as they become more comfortable with the services they receive
- Entering into a Build-Operate-Transfer (BOT) model
- Combination of the above options

[1] Maurice F. Greaver II (1999), *"Strategic Outsourcing: A Structure Approach to Outsourcing Decisions and Initiatives,"* American Management Association, New York. p.3.

As a special risk strategy, a company can outsource its processes to:

- several companies in the same offshore jurisdiction; or,
- companies in different jurisdictions.

Thus, if one service provider were unable to comply with its commitments due to political, legal, or economic reasons, the outsourcer would not be adversely affected, as other service providers in the same or different jurisdictions can ramp up their operations to service the needs of the outsourcer.

## Countries for Offshore Outsourcing

India, the Philippines, China, Mexico, Ireland, Poland, Australia, Hong Kong, Russia and New Zealand are some of the leading countries for offshore outsourcing. While evaluating the countries to which services can be outsourced, the parameters considered include availability of skilled manpower, cost of salaries and infrastructure, availability of land, telecommunication equipment, bandwidth and other infrastructure, Government support and assistance, legal environment and maturity of the markets/companies.

## Advantage India

India offers a strong value proposition among all IT-enabled services hubs for the following reasons:[2]

- **Skilled Manpower:**
  India's abundant skilled manpower is drawing corporate hubs to back end their operations in India. The country's English speaking manpower rates high in qualifications, capabilities, quality of work, and work ethic. This places India ahead of competitors such as Singapore, Hong Kong, China, the Philippines, Mexico, Ireland, Australia, and Holland, among others.

- **Competitive Salary Levels:**
  Salary levels in India are lower than most salary levels in other countries that have become centers for offshore outsourcing. Since cost cutting is one of the primary reasons for outsourcing, the cost advantage offered by India makes it the most attractive destination for outsourcing.

- **Training Centers and Institutions:**
  India has several educational institutions that provide educated and skilled manpower. There are also several institutes that train people specifically for jobs in the BPO space.

- **People, Environmental, and Infrastructural Factors:**
  Three factors-the people, environment, and infrastructure contribute to a healthy BPO setting, particularly in the ITES space. These factors are evaluated in the graphs below for India, China, the Philippines, Ireland, and Mexico. Each factor is weighted differently in terms of importance. As per a KPMG Report on ITES in India, India ranks the highest under "People Factors" compared to China, Philippines, Ireland and Mexico.

- **Geographic Location:**
  India's unique geographic position enables it to offer a 24x7 service and quicker turnaround by leveraging the time zone differences.

- **Government Initiatives:**
  The central and state governments are actively supporting the outsourcing industry and are implementing favorable policies. Many state governments, such as those of Karnataka, Andhra Pradesh and Tamil Nadu have adopted, or are in the process of adopting BPO policies to make their states more attractive for foreign investment. These states are taking various initiatives - such as amending the labor laws-to permit women to work at night, offer flexible timings, and to allow for the self-certification of compliance with certain labor laws. These states are also attracting BPO companies by offering rebates on registration and the transfer of property and a waiver of the conversion fee for land.

- **Tax Incentives:**
  BPO services are categorized as Information Technology Enabled Services (ITES), and several special tax incentives have been granted to ITES companies. The entire export profits of the ITES companies are exempt from tax until March 31, 2009.

- **Industry Associations and Institutions:**
  There are several associations, such as NASSOM, CII, and the Federation of Indian Chambers of Commerce and Industry (**FICCI**), which actively represent the interests of the ITES players. These associations have been instrumental in bringing about changes in regulations and policies to develop the ITES market.

- **Telecommunications and Infrastructure:**
  The availability of telecommunication facilities and the cost of these services have traditionally been areas in which India has not performed well. High rates for property, stamp duty, and the restriction of foreign investment in property in India have been additional hurdles faced by foreign investors.

  However, it should be noted that the quality of India's infrastructure has been improving. The liberalization of the telecommunication sector has resulted in several competing players, which has led to a decrease in the cost of telecommunication services. The government has permitted private companies to set up international gateways and has also allowed for Internet telephony. The proactive attitude of the Indian government to facilitate the growth of the ITES/BPO sectors can be gauged by the recent policy changes that have been implemented. The government has permitted international call centers to have foreign-end connectivity through managed services from international long distance players. Further, the Department of Telecommunications has allowed foreign-end connectivity in international call centers through the use of technologies such as ATM/MPLS/Frame Relay-based managed international networks, in addition to the connectivity through point-to-point international privately leased circuits (IPLCs). Until now, international call centers, including GE and American Express, could connect to their clients in the US and UK only through IPLCs of two Mbps.[3] Companies have been establishing their presence in satellite townships in which the land prices are lower and some governments have relaxed certain stamp duties for ITES companies. The government is actively improving the transportation systems in India by building new highways and undertaking other infrastructure development projects. States have set up telecommunications/BPO parks, thereby enabling companies to have access to telecommunications, bandwidth, power, and other infrastructure required for smoother operations.

- **Reputation of Indian Software Companies:**
  Indian companies have gained a formidable reputation in the software services industry. The listing of Indian software companies in the US such as Infosys, Silverline, and Wipro, has improved the visibility and acceptance of Indian companies by US corporations. BPO companies are leveraging this acceptance to gain greater visibility in the BPO space.

[2] http://www.nasscom.org/artdisplay.asp?cat_id=326, visited on September 24, 2002.
[3] http://economictimes.indiatimes.com/cms.dll/html/uncomp/articleshow?msid=153925, visited on September 12, 2003.

- **Maturity of Indian BPO Companies:**

  Many Indian BPO companies not only have set up large-scale operations in India but also have made investments abroad or acquired foreign companies in the BPO space. For example, ICICI OneSource, the BPO arm of ICICI, is also looking to start operations in the Philippines by the end of 2003.[4] Following the acquisition of a contact center in Ireland, HCL Technologies is now setting up a contact center in Malaysia.[5] Progeon, Infosys's BPO subsidiary, is planning to set up its first overseas center in the Czech Republic and is in the process of filing an application with the Czech government.[6]

- **Investment and growth potential:**

  As of March 31, 2003, $1 billion had been invested in the Indian BPO sector.[7] Global IT research and advisory firm Gartner, Inc. expects India's revenues from BPO to reach the $13.5 billion mark in 2007.[8] Venture capital (VC) and private equity firms made ten investments for about $35 million in Indian companies during the quarter ended June 30, 2003.[9]

All of these factors combined provide unique advantages for outsourcing to India and have increased the comfort levels of foreign companies choosing India for their offshore outsourcing.

### Expected Growth Rate in India

The following chart shows the estimates of revenue generation in the BPO sector.

| Revenue\ Year | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | CAGR |
|---|---|---|---|---|---|---|---|
| Offshore BPO Revenue | 1,322 | 1,825 | 3,017 | 6,439 | 12,563 | 24,230 | 78.91 |
| Indian BPO Revenue | 912 | 1,205 | 1,961 | 3,928 | 7,412 | 13,811 | 69.35 |
| Total BPO Market | 110,167 | 121,687 | 131,171 | 143,090 | 157,033 | 173,070 | 9.45 |
| CAGR in % 2002-07 | | Figures in $million | | Source: Gartner Dataquest (May 2003) | | | |

*Table Courtesy: http://www.bpoindia.org/knowledgeBase/*

## BPO Companies in India

Indian BPO companies can be categorized by the services they provide and their ownership patterns.

- **Services**

Services being offered by Indian Companies include Customer Interaction, including call centers, back office processing, transcription services, digital content development, Geographic Information Services, Contact Research Services (CRS) and back office legal services.

- **Shareholding pattern**

With the realization of the tremendous scope of the BPO market, several players have set up BPO operations. The BPO companies in India can broadly be classified as Wholly-Owned Subsidiaries of Multinational Corporations, Venture Capital-Backed Startups and Private Equity Investments, software companies and large business houses making a foray into the ITES space.

## BPO Operations In India

Once a foreign company decides to use India for its outsourcing services, it is necessary to determine the appropriate structure for operating in India, the procedure for setting up and operating a BPO company in India and the exit options available for the foreign company.

### Structuring of Operations in India

A foreign company can use India for its outsourcing needs by:

- **Entering into an Agreement with an Indian BPO Service Provider**

  India has emerged as one of the most widely accepted offshore outsourcing centers. Indian companies provide a wide spectrum of services such as customer interaction (including call centers), back office operations (including revenue accounting, data entry, data conversion, finance and accounting services), human resource services, medical transcription services, data digitization, etc.

  Several MNCs, such as GE, Dell, British Airways, Citibank, American Express, Microsoft, Hewlett Packard, and Amazon have outsourced their back office and support services to India, as a result of which India is known as the back office to the world.

- **Equity Participation in an Indian BPO Company**

  Foreign companies can set up wholly-owned subsidiaries or joint ventures in India to provide outsourcing services. While considering investing in BPO companies in India, it is necessary to examine the exchange control and structuring issues.

  a. Foreign Direct Investment (**FDI**) in BPO companies

  According to the exchange control regime in India, 100% FDI has been allowed in the software industry or ITES space on an automatic basis (i.e., there is no need to obtain the prior approval of any regulatory authority). Since the activities of BPO companies can be categorized as "IT enabled services," 100% FDI is permitted in these companies under the automatic route.

  According to the guidelines issued by the Department of Telecommunications (**DoT**), 100% FDI is permitted in call centers.[10] However, until recently the call center guidelines had stipulated that no more than 49% FDI was permitted in call centers involved in e-commerce activities. The DoT approvals had stated that 100% foreign equity was permissible in a call center, provided the call center was not providing *"e-commerce related services."* Since the term *"e-commerce related services"* had not been defined, the above guidelines were ambiguous and had created some confusion as to the amount of equity permissible in call centers providing *"e-commerce related services."* The revised guidelines state that 100% FDI is permitted in call centers. Further, the new guidelines do not distinguish the FDI limit based on the call center activity.

  b. Investing in India: The Mauritius Route

  As mentioned above, a foreign company can establish a wholly-owned subsidiary or enter into a joint venture with an Indian party. In either case, the foreign company can route its investment into India through a tax efficient jurisdiction such as Mauritius, to avail itself of the benefits of the India-Mauritius Double Taxation Avoidance Agreement (**India-Mauritius DTAA**). According to the provisions of the India Mauritius DTAA, capital gains realized by a Mauritius resident company from the sale of shares in an Indian company should be subject to tax only in Mauritius and not in India, provided that the Mauritius company

[4] http://economictimes.indiatimes.com/cms.dll/html/uncomp/articleshow?msid=31505, visited on September 12, 2003.
[5] http://economictimes.indiatimes.com/cms.dll/html/uncomp/articleshow?msid=34306, visited on September 12, 2003.
[6] http://economictimes.indiatimes.com/cms.dll/html/uncomp/articleshow?msid=196552, visited on September 23, 2003.
[7] http://www.bpoindia.org/knowledgeBase/, visited on September 12, 2003.
[8] http://finance.indiainfo.com/news/2003/07/15/15bpo.html, visited on September 12, 2003.
[9] http://economictimes.indiatimes.com/cms.dll/html/uncomp/articleshow?msid=62423, visited on September 12, 2003.
[10] http://www.dotindia.com/callcenter.PDF, visited on September 17, 2002.

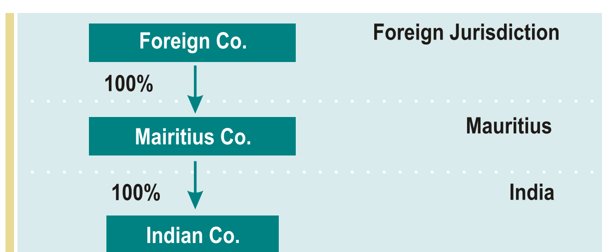
does not have a permanent establishment in India. Further, according to the domestic tax laws of Mauritius, capital gains are not taxable on such a sale. Hence, the interposing of a Mauritius holding company could be useful to eliminate capital gains tax, thereby making the Indian investment attractive. The need to implement a Mauritius entity should be ascertained on the basis of the business objectives. It should be noted that Mauritius is the largest single foreign investor in India.

Some doubts about the availability of benefits under the India Mauritius DTAA were raised on account of a Delhi High Court ruling, which quashed a Circular [11] passed by the Central Board of Direct Taxes (**CBDT**) on the India-Mauritius DTAA. The Circular, *interalia*, stated that the "Certificate of Residence" (commonly referred to as a tax residency certificate) issued by the Mauritius tax authorities would constitute sufficient evidence as to residence and beneficial ownership in Mauritius for entitlement to the benefits of the India-Mauritius DTAA. The Circular had merely reiterated the provisions of the Treaty, which states that where a Mauritius "person" is found liable for tax in India, the determination of the person's residency shall be made in accordance with the domestic laws of Mauritius. In the last week of September 2002, the Government of India and the CBDT, being respondents in the proceedings before the Delhi High Court, jointly filed a Special Leave Petition (**SLP**) before the apex court, challenging the Order. Global Business Institute Ltd. (GBI), a not-for-profit company incorporated under the laws of Mauritius, also filed an independent SLP. The Supreme Court took up both SLPs together for hearing. The Judges heard the matter on an expedited basis, with hearings being held thrice a week beginning January 28, 2003. The last and final hearing was on February 25, 2003. Since the matter involved important issues of international law, the Judges had reserved their judgement. The Supreme Court finally pronounced its judgement on October 7, 2003 quashing the Delhi HC order and upholding the validity of Circular 789. Thus, foreign investors investing into India through a Mauritius intermediate holding company are entitled to claim benefits under the India Mauritius DTAA. In January 2004, one of the original petitioners before the Supreme Court, filed a curative petition pleading to the Supreme Court to, *inter-alia*, review the original order passed and 'curate' or redo the same. On December 8, 2004 the Supreme Court dismissed the curative petition upholding its original order dated October 7, 2003.

Indian BPO companies are also provided special tax incentives, which are discussed in detail below. Until recently, these tax benefits were lost if the beneficial ownership of the company changed by more than 49%. However, the Finance Act, 2003 removed this restriction and therefore a change in ownership of the Indian company would not have any adverse tax implications on the tax holiday.

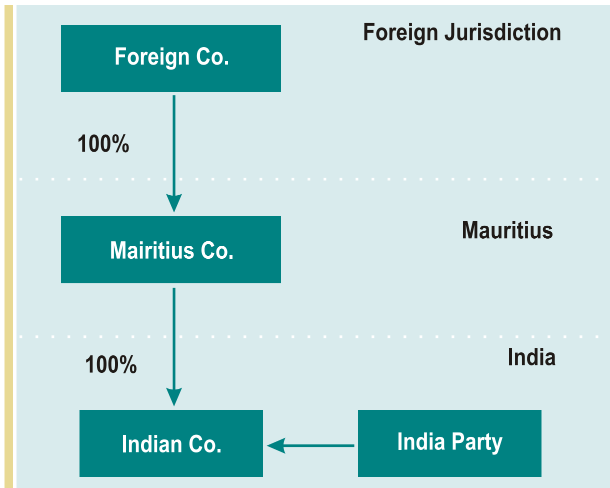
### c. Wholly-Owned Subsidiaries

Several foreign companies, such as General Electric, Dell, and Prudential, established wholly-owned subsidiaries in India, which are captive BPO service providers.




### d. Joint Ventures

The foreign company can also enter into a joint venture with an Indian party. The joint venture company can provide services to the foreign company and also to third parties. Indian parties can use the joint venture route to receive foreign investment and technological know-how from established players in foreign jurisdictions.




While considering the percentage ownership that a party wishes to have in a company, it is necessary to understand the mechanism of exercising control over an Indian company. Control can be exercised at the board and at the shareholder level.

There are two types of shareholders' resolutions under Indian law:

> **Ordinary Resolutions:** These resolutions require the approval of a majority (51%) of the shareholders. Such resolutions are required for, among other reasons, increasing the share capital, declaring dividends, appointing auditors, and increasing or reducing the number of directors.
>
> **Special Resolutions:** These resolutions require a 75% majority. Such resolutions are required to change the name of a company, altering the Articles of Association, offer further shares to any other people, and to wind up the company's affairs.

Thus, a shareholder would require at least 75% of the company's shares to be able to control its operations, unless the Articles of Association specified otherwise. Conversely, a shareholder who holds 26% of the shares of a company has statutory veto rights, which would entitle him/her to have negative control over the company.

It is possible for the minority shareholder to protect his/her interests by having shares with differential voting rights or with a negative veto right over certain matters, where a decision cannot be taken without the minority shareholders' consent. Thus, it is important to carefully negotiate the shareholders' agreement and incorporate adequate control mechanisms.

[11] Circular No. 789 dated April 13, 2000.

## Sources of Income for Foreign Companies

The foreign company can receive income from an Indian company in the form of dividends, interest, royalties, or service fees.

- **Dividends:** The foreign company can repatriate the profits of the Indian company in the form of dividends. Such dividends are usually declared from the profits of the Indian company. The Finance Act, 2002, had reintroduced the classical system of taxation (i.e., taxing dividends in the hands of shareholders). The Finance Act, 2003 restored the position to pre 2002 with some modifications. Accordingly, dividends are now made tax-exempt in the hands of all shareholders (irrespective of their residential status). However, the dividend distributing company would have to pay a dividend distribution tax of 12.81%. [12]

- **Other Sources:** Since there are no thin capitalization norms in India, the Indian company may be structured to have a higher debt component with the foreign company providing loan to the Indian company. The Indian company can receive up to $50 million under the automatic route (i.e. no prior approval of any regulatory authority would be required), subject to certain conditions. However, it should be noted that there are certain restrictions on the amount of interest that can be paid on such loans.

  The foreign company can license its trademark, software, and other intellectual property and receive royalties for such use. The foreign company may also provide training and other services to the Indian company and receive fees for such services.

  The Indian company would be required to withhold tax at the source at the rate of 20% on the interest, royalty, and service fees which rate could be reduced depending on the DTAA between India and the foreign company's country of residence. However, Finance Act 2005 has reduced the rate to 10% under the Income Tax Act, 1961 (**"IT Act"**). This reduction would therefore be useful for non residents coming from non treaty jurisdictions as the domestic tax rate would now be line with lower rate under some of the Indian tax treaties.

## Tax Issues

A BPO operation that is run from India will have tax implications in India. These implications need to be carefully considered when deciding between setting up operations in India or outsourcing to a third party.

| INCOME TAX RATES IN INDIA | |
|---|---|
| **Category** | **2005 - 06** |
| **Individuals (Resident and Non - Resident) - maximum rate** | **33.66%** |
| **Indian Companies** | **33.66%** |
| **Foreign Companies** | **41.82%** |

Under the IT Act, all Indian source income is subject to tax in India. The income tax rate changes every year. The table at the left shows the present rates of income tax for the financial year 2005-06.

If the foreign customer sets up a subsidiary in India, the Indian subsidiary would be subject to a 33.66% tax on its net income. If the foreign customer company were to operate out of a branch office in India, the branch could be regarded as a permanent establishment of the foreign company in India and hence be taxed at 41.82% on its net income.

- **Tax Benefits:** As stated earlier, companies engaged in BPO activities are entitled to tax holidays under section 10A and section 10B of the IT Act. Units set up by these companies in Free Trade Zones (**FTZs**), Electronic Hardware Technology Parks (**EHTPs**), Software Technology Parks (**STPs**), or Software Export Zones (**SEZs**) are entitled to certain exemptions on profits generated from exporting articles, things, or computer software. The term *"computer software"* under the IT Act has been defined to include IT enabled services such as data processing, data entry and conversion, data analysis and control, and data management call center operations.[13]

  The entire export profits of a company that is set up in an STP, SEZ, FTZ, or EHTP are exempt from tax until March 31, 2009. Further, all SEZ units that commence production on or after April 1, 2002 receive a 100% income tax exemption for a period of five years and a 50% deduction for an additional two years. For the three consecutive assessment years thereafter, the undertaking would be entitled to an exemption (not exceeding 50% of the profits) provided such amount is credited by the undertaking in a "SEZ Re-investment Allowance Reserve Account." Further, it is important to reiterate here that vide the Finance Act, 2003 the restriction on the loss of tax benefits upon change in the beneficial ownership of the company by more than 49% has been removed. The IT Act also provides that in case of an amalgamation/demerger, the amalgamated/resulting company to which the undertaking enjoying the tax holiday is transferred, will now enjoy the tax holiday for the balance period to which the amalgamating/transferor company would have been entitled. However, the amalgamating/transferor company will not be entitled to claim the tax holiday for the fiscal year in which such reorganization takes place.

  Further, companies engaged in the business of exporting computer software, or providing technical services outside India in connection with the development of computer software, were entitled to a deduction in their profits while computing their total income.[14] However, this benefit was being reduced in a phased manner and has now expired whereby it is no longer available.

- **Transfer Pricing:** The parties to a BPO agreement may also be required to comply with transfer pricing regulations, which took effect in India on April 1, 2001.[15] The regulations state that the income arising from an international transaction entered into by associated enterprises should be computed based on an arm's length price.

  It would be pertinent to note that the definition of the term *"associated enterprises"* under the IT Act is broad. For example, if

[12] All income rates mentioned in this paper are inclusive of the currently applicable surcharge of 10% for domestic companies an d individuals having an income in excess of INR 10,00,000, 2.5% in case of foreign companies and education cess of 2% on tax and surcharge.
[13] The definition of "computer software" has been broadened and includes IT enabled services like data processing, data entry and conversion, data analysis and control, data management, call center operation, etc. vide notification no. 11521/F.No. 142/49/2000-TPL dated 26 September 2000 issued by the CBDT, India.
[14] Section 80HHE of the IT Act.
[15] Sections 92 to 92F of the IT Act.

one enterprise holds shares either directly or indirectly, holds at least 26% of the voting power of the other enterprise, or advances a loan to the other enterprise equal to at least 51% of the book value of the total assets of that other enterprise, the parties may be regarded as associated enterprises and would be required to comply with transfer pricing regulations.

- Permanent Establishments (**PEs**): As stated earlier, a company may carry out operations in India through a branch office, a subsidiary company or through a joint venture. However, while selecting the form of entity through which business operations may be carried out in India, one should consider the possibility of the Indian entity being regarded as the PE of the foreign company. If the foreign company were to operate out of a branch or an office or have a place of management in India it would be regarded as a PE. If the foreign company is held to have a PE in India, the profits of the foreign company, attributable to such PE would be taxed in India.

A subsidiary per se will not be regarded as a PE. Though the mere existence of a subsidiary by itself will not constitute a PE, it would be pertinent to note in this regard, the rulings passed by the Indian courts.

In a ruling[16] issued by the Authority for Advance Rulings, India (**AAR**), the AAR held that a subsidiary may be regarded as a PE if it does not have significant independent activities of its own. In another ruling, the AAR held that if the agent does not have the authority to conclude a contract, then he / she cannot constitute a PE.[17] However, if the parent executes mass contracts made on standard forms without scrutinizing such forms, then the agent may constitute a PE.

In the event that foreign company is held to have a PE in India, the profits of the foreign company to the extent attributable to the operations of Indian PE will be subject to tax in India. The BPO industry got a rude awakening when the CBDT issued circular 1 of 2004[18] (**"Circular"**) regarding the extent of attribution of global profits of non-residents engaged in BPO activities to taxation in India. In order to "clarify" the attribution rules vis-à-vis the BPO industry, the Circular classified the nature of the BPO activities in India into "incidental"[19] and "core"[20] activities. The Circular stated that when a non-resident entity outsources some of its incidental activities to India and the Indian BPO unit is compensated on arm's length/fair market price for the same, no income shall separately accrue or arise to the non-resident entity in India. However, where the non-resident outsources the whole or part of its core revenue generating business activities to a BPO unit in India, then *"a considerable portion of the profits derived by the non-resident or the foreign company from its customers abroad would certainly be attributable to the activities performed by the BPO unit in India."*

The Circular followed by the speech of the Indian Minister of Finance sent tremors down the BPO lane. It created anxiety and uncertainty in the minds of domestic and foreign BPO players who had or were planning to invest millions in the Indian BPO boom. It was believed that the Circular was not in alignment with the widely accepted principles of international taxation enshrined in the tax treaties and commentaries thereto, especially with regard to captive subsidiary per se not constituting a Permanent Establishment (**"PE"**) of its parent. It also meant a deathblow to R&D and software activities being outsourced to India as these activities were characterised as "core" activities subject to "significant" attribution without providing any clarity on the mechanism for such attribution. Based on the Circular, some income tax officers had raised demand notices on R&D subsidiaries holding them out to be PEs of the foreign parent companies. Professional and industrial associations/organizations had made representations to the Government of India seeking clarity behind this stance taken by the CBDT. The Circular is now proposed to be withdrawn.

On August 9, 2004, the CBDT issued a new draft circular to replace the Circular and the same has been put up for public comments. This circular was issued in final form on September 28, 2004 ("New Circular"), with the issuance of which the controversial Circular stands withdrawn with immediate effect.

The New Circular clarifies that the non-resident/foreign entity outsourcing operations to India would be liable to tax in India only if the BPO unit constitutes its PE as per the provisions of Article 5 of the DTAA between India and the country of residence of the foreign company. As per the New Circular, profits of a foreign entity would be taxed in India only to the extent the amount is attributable to the PE in India. For this purpose, the amount attributable to tax in India would be the amount determined as per arm's length principle. Arm's length price would be the same as defined in Section 92F(ii) of the IT Act i.e. the price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions. While computing the profits of the PE, the expenses incurred in connection with the activity of the PE in India would be allowed as deduction in accordance with the accepted principles of accountancy and the provisions of the IT Act.

Laudatory in its intent, the New Circular, nonetheless, is still silent on some crucial issues that could be addressed by the CBDT to bring certainty of tax implications for the foreign investors. For example, the New Circular has not addressed the issue of taxation of BPO units set by foreign entities coming from non-treaty countries, extent of attribution, etc. These issues would continue to be stumbling blocks at the lower income tax authorities level. However, withdrawal of the original circular, which sought to attribute higher profits to core activities outsourced to India, is a welcome move.

## Setting Up Operations in India

The following issues have to be addressed while setting up operations in India:

- Incorporating a company
- Registering with the Software Technology Parks of India **(STPI)**
- Approval by the DoT for call center

- Incorporating a Company: There are two main types of companies in India, public and private companies. It is advisable to set up Indian operations in the form of a private company rather than a public company because the former has more flexibility and is easier to operate than compared a public company. It normally takes 30-40 days to incorporate a company in India.

[16] [1997] 223 ITR 416 AAR P.No. 8 of 1995.
[17] TVM Limited Vs. CIT (Delhi) [1996] 237 ITR 230 (AAR).
[18] Dated January 2, 2004. Text of the Circular is attached herewith as Annexure 1
[19] Incidental activities: "mere procurement of orders for sale of goods or provision of services and answering sales related queries, to the provision itself of service, like software maintainence service, debt collection service, software development service, credit card/mobile telephone related service, etc." Circular 1 of 2004.
[20] Core activities: "services of a travel agent, software developer, software maintenance, investment consultant, debt collection service etc." Circular 1 of 2004.

- Registering with the STPI: As discussed above, certain tax benefits are available to 100% EOUs registered with the STPI. The STPI grants approval to establish a unit and specifies the amount of capital goods that can be imported, the minimum export performance, and the net foreign exchange earnings as a percentage of exports (**NFEP**). The units in the STPI are also granted certain indirect tax benefits, such as an exemption from payment of custom duties. If a unit does not achieve the NFEP or export performance, the unit may be required to refund the tax benefits it has received under the STPI scheme.
- Approval by the DoT: An approval has to be received from the DoT for setting up a call center in India. The DoT Guidelines on call centers classify them within the ambit of "Other Service Providers."

## Exit Options

The shareholders of the Indian BPO company can exit the company in the following ways:

- Transfer of shares of the BPO company
- Other routes

### Transfer of Shares of the BPO Company

The shareholder of the BPO company can transfer its shares to a third party. Under Indian exchange control laws, the transfer of shares from a resident to a non-resident and vice versa, until recently required prior regulatory approvals. The Reserve Bank of India (**RBI**) has vide its circular dated October 4, 2004 done away with need for obtaining such approvals provided the transfer meets the pricing guidelines and the parties make the necessary post transfer filings in the prescribed form together with annexures.

It should be noted that one of the conditions imposed by the DoT while granting approval for setting up a call center is that there should not be any change in the Indian or foreign promoters / partners (or their equity participation) without the prior approval of the "competent authority."

The above-mentioned transfer of shares may also have certain tax implications, which are discussed below.

#### Capital Gains

Under the provisions of the IT Act, gains realized on the sale/transfer of shares of the Indian company by the foreign company would result in capital gains tax in India.[21] Long-term capital gains[22] realized on the sale of shares of Indian companies not listed on a recognized stock exchange in India will be taxed at the rate of 20% (with a cost inflation indexation benefit). Long term capital gains on sale of equity shares of companies listed on a recognized stock exchange in India (where such sale has suffered securities transaction tax), would be exempt from tax, whereas short term capital gains in such sales would be taxed at the rate of 10%. In other cases short-term capital gains[23] is taxed as normal income, so for example, short capital gains realized by a domestic company will be subject to tax at the rate of 33.66%. However, it may be possible to reduce the capital gains tax to zero, if the investments are routed through Mauritius and the operations are structured so as to avoid PE classification in India. It may also be noted that in cases in which the parties to the transaction are related, the Indian transfer pricing provisions would also be triggered.

### Other Exit Routes

The shareholders of the BPO company can exit via an IPO. However, if the shareholders are treated as *"promoters"* of the company, there are certain lock-in requirements on the shares held by such promoters. The shareholders can also exit from the BPO company through a merger of the BPO company with another company or after a winding up of the Indian company.

## BPO Agreements

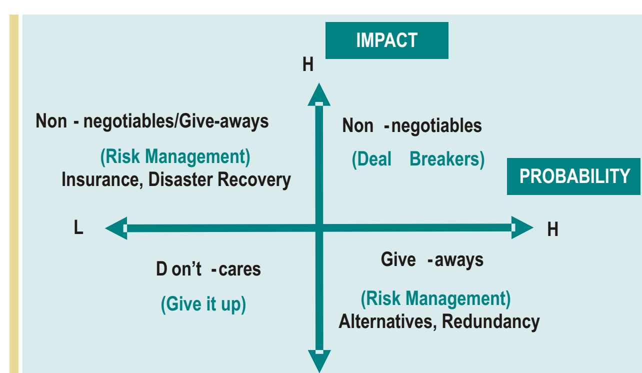
### Types of BPO Agreements

Depending upon the relationship between the parties and the nature of transaction, the BPO agreements could be :

- Third Party Agreements for BPO, where the customer and the vendor are not related parties;
- Captive Agreements for BPO, where the customer and the vendor are related parties, the vendor typically being the subsidiary of the customer;
- Build-Operate-Transfer (BOT) Agreements, where the vendor builds and develops the BPO operation for the customer and at a future date transfers it to the customer.

### Drafting and Negotiating BPO Agreements

Since the foundation of any outsourcing relationship is laid out in a BPO contract, it assumes tremendous importance and should be drafted and negotiated carefully - keeping in mind business, operational and legal risks - to ensure the long-term success of the BPO arrangement. The Contract must capture the unique business strategies and concerns, as well as the commercial understanding of the parties. Each issue of the transaction should be categorized under Non-negotiables, Give-aways and Don't-cares. This approach helps the party assess its bargaining power and also assists the party in setting up an effective negotiation strategy. Such categorization should be done on the impact vs. probability theory, as depicted below :




Incomplete documentation of the supplier's obligations can result in customer dissatisfaction and disputes. The following are some of the key issues that have to be addressed in the agreement.

- Scope of Services: The agreement should clearly detail the services to be rendered, the resources to be used for providing the services and ramp-up provisions in case of widened scope of services.
- Service Levels: These provisions include specification of the deliverables, performances to be measured, methods for measuring service levels, periodic reporting, and root-cause

[21] S. 45 of the IT Act.
[22] Gains realized on the transfer of shares held for more than 12 months are deemed long-term capital gains.
[23] Gains realized on the transfer of shares in a company held for a period of 12 months or less are called short-term capital gains.

analysis of service level failures. Agreements may also link the consideration payable to the performance through "service level credit,"[24] and bonuses

- **Service Fees:** The fees could be a lump sum amount or based on various factors such as the number of e-mails/phone calls responded to. While determining the fees payable to the service provider, especially in case of captive outsourcing, the transfer pricing issues should be borne in mind.
- **Managing the Service Provider:** To maintain control over the operations of the service provider and maintain stability and continuity the agreement can contain conditions prohibiting the removal of a senior member of the service team without approval of the company, as the person would have gained a comprehensive understanding of the client's needs and any replacement would require some time to achieve the same degree of familiarity. The customer may impose training requirements on the agents working on the transaction, seek reports on performance levels, and require the service provider to have the latest technology and infrastructure. The customer may also prohibit the service provider from subcontracting/assigning its services to a third party without the client's consent.
- **Intellectual Property (IP):** In any outsourcing agreement, there could be several IP issues involved, such as the licensing or assignment of copyrights, trademarks, and patents, etc. The issues concerning IP would largely depend on whether the IP is licensed by the service provider or the customer, or developed by the service provider.

  a. IP Owned / Licensed by the Service Provider:
  If the service provider claims that it owns, or has the right to use software which is required to provide the services, the customer should examine the license agreement or seek a representation and warranty stating that there is a valid right to use such software. the customer would normally impose an obligation on the service provider to do all that is necessary to maintain the license's validity. If the service provider claims ownership of particular software, the customer would require a representation and warranty that the software does not violate the intellectual property of any third party. If the software violates any third party's rights, the service provider would be under an obligation to use similar non-infringing software or to obtain a license from the software's owner, without any cost to the customer. The customer would also seek an indemnification against any suit that may be brought against it due to the infringing software. The service provider may also own other types of IP, such as patented inventions that it uses to perform the services under a BPO agreement. In such a case, the service provider should be obliged to ensure that it continues to own the IP during the term of the agreement.

  b. IP Owned / Licensed by the Customer:
  The customer may provide the vendor with operations manuals, systems documentation, and even computer hardware and software in order to perform the outsourced services. The service provider may have a license to use such software, or the customer may receive such a license and provide a sub-license to the service provider. The service provider may also grant a license to the customer to use the service provider's trademark. In the case of licensed trademarks, the agreement must stipulate how and for what activities the trademarks may be used. The service provider must ensure control over the right to use the trademark because it may suffer a loss of goodwill due to the acts of the customer. In addition, while providing services to the customer, the service provider would have access to confidential information, trade secrets, and other intellectual property of the customer. Such information would continue to remain the intellectual property of the customer. Sometimes a customer may need to license certain patented inventions that it uses for its business processes, to the service provider. In such a case, the contract should regulate the manner in which the service provider uses the patented invention. If the software is owned or licensed by the customer, a limited license is granted to the service provider to enable it to provide the services. The customer should ensure that the service provider does not use the software for any other purpose or customer, or sub-license it to any third party. The service provider should seek an indemnification from the customer against any suit that may be brought against the service provider due to the infringing software.

  c. Developed IP:
  Intellectual property may be developed by the service provider while providing services to the customer. The agreement should clearly state the ownership of such intellectual property. Such intellectual property would normally vest with the customer and an obligation is imposed on the service provider to assign such IP to the customer. The agreement would have to specify that the customer is not under any obligation to make any additional payments for the assignment of such intellectual property. Alternatively, the parties could be co-owners of the intellectual property and they could share the revenues received by licensing such IP to a third party.
- **Privacy and Data Protection**
  While providing services, the service provider would have access to personal and confidential data of the customer's clients. The customer would usually be under a contractual and a legal obligation to protect the privacy of its clients. The importance that governments attach to privacy issues can be gauged by the global developments with respect to privacy regulation.

  a. Privacy Laws in the US: The US historically favored self-regulation for privacy protection, and until recently, there were few privacy laws to consider in outsourcing transactions. However, due to increasing pressure from consumer protection groups, there is a variety of legislation that addresses privacy issues and data protection.

  To address some of these concerns, the US Congress enacted the Gramm-Leach-Bliley Act, which governs personal financial information; the Health Insurance Portability and Accountability Act (HIPAA), which covers health and medical information; and the Children's Online Privacy Protection Act (COPPA), which governs information collected online from children under the age of 13.

  b. EU Directive on Data Protection: Outside of the US, privacy regulation is developing at a rapid pace. Multinational companies, or companies that simply receive data from other countries, may be subject to local privacy regulations. The European Union (EU) has been a leader in enacting and enforcing privacy regulation. For example, the EU's Directive on Data Protection[25] provides several rules that companies in the EU have to comply with while collecting and using personal information. In addition, it establishes a general rule that data should only be transferred to a non-EU country if it will be adequately protected there.[26]

[24] A service level credit is a credit that the vendor grants to the customer after a service level failure.
[25] EU Directive on Data Protection: http://www.privacy.org/pi/intl_orgs/ec/final_EU_Data_Protection.html, visited on June 6, 2002.
[26] The Directive, however, does not define the meaning of "adequate." Nevertheless, it provides that adequacy determinations will be made on a case-by-case basis, taking into account all the circumstances surrounding a data transfer operation.

c. Indian Laws on Data Protection and Privacy: Currently, the Indian legal regime does not have specific legislation for privacy and data protection. However, Indian courts have interpreted the right to privacy as an unarticulated fundamental right against an action by the state. Though the Information Technology Act, 2000 addresses the issue of protecting privacy rights, it only protects privacy rights from Government action. It is unclear whether such protection would be extended to private actions. The lack of adequate privacy protection in India may act as a disincentive for companies in the EU to outsource business processes to Indian companies. However, India is expected shortly to enact legislation addressing the issues of privacy and data protection.

It is necessary for an Indian company to be aware of the legislation in its customer's country, as it could have an impact on the service provider. It may be difficult for Indian companies to keep abreast of the latest legislation in foreign jurisdictions that would have an impact on the services that the Indian company provides to a foreign company. Hence, an obligation may be imposed on the customer to update the service provider on the foreign laws and the amendments to which the service provider must adhere. If the service provider does not comply with these laws, an indemnity obligation may be imposed on it.

Companies should take various steps to ensure that they minimize the risks of unauthorized access to sensitive personal information. Understanding the impact of privacy laws on one's business is the first step. Businesses should appoint a privacy team that will lead them through the assessment, planning, communication, and eventual compliance steps. For example, an appropriate team might include representatives from the following areas: HR, legal, marketing, communications, technology, finance, and corporate strategy. Corporations such as IBM, Microsoft, and AT&T have appointed "Chief Privacy Officers" and privacy teams to lead the effort in helping those businesses meet privacy compliance requirements.

## Other Issues

a. Avoid Vagueness: The agreement should have clear definitions of the terms used in the agreement. Parties often leave certain aspects to be "mutually decided" in the future. In the event the relationship between the parties sours, such mutual agreement is difficult to reach. Issues that are likely to have a long-term impact should not be left open.

b. Noncompete Provisions: The customer would typically insist upon a non-compete clause. The parties would have to negotiate a fair and enforceable noncompete clause. The vendor may in return insist upon an exclusivity clause.

c. Nonsolicitation: The customer may often seek to employ high-skilled employees of the vendor and therefore, the vendor should include a nonsolicitation clause.

d. Tax Matters: The BOT transaction has to be structured in a manner such that even after the transfer of operations the tax benefits are retained, and for that purpose relevant clauses have to be added in the agreement.

e. Transfer Pricing and Permanent Establishment Issues: The captive contracts and BOT agreements have to take into account transfer pricing and permanent establishment issues, and the relevant clauses must be inserted in the agreement.

f. HR issues: In the case of BOT Agreements, HR issues should be tackled carefully, as the vendor's employees are required to be transferred to the customer at a later date. Therefore, the employee contracts of the vendor have to be carefully drafted.

g. Limitation of Liability: The vendor should negotiate a limitation of liability provision in the contract, whereby the vendor's liability could be limited only to the extent of the fees being paid by the customer or to the extent that the loss or damage is on account of a default on the vendor's part.

h. Technology and Infrastructure: The customer should also ensure that the vendor has the latest technology and infrastructure in order for the services to be rendered in the most efficient manner.

i. Prohibition or Limitation on Vendor to Subcontract/Assign the Contract Services: In order to ensure control over the manner in which the services are provided, restrictions could be implemented prohibiting the vendor from subcontracting or assigning its services to a third party without the customer's consent.

## Term and Termination

This is one of the most important clauses in a BPO agreement, as the business plans of both the parties can be adversely affected by an early termination of the agreement.

a. Automatic Renewal: As discussed earlier, the agreements in the BPO market are usually for a long time period and have high rates of renewal. The agreements usually specify the term of the agreement and provide for automatic renewal, unless the parties expressly terminate the agreement.

b. Termination for Default: The agreement should grant an aggrieved party the right to terminate the agreement in case of material default of agreement or its representations and warranties.

c. Termination for Convenience: The parties may also have a right to terminate the agreement, even if there is no default by the other party. Such termination would usually require the payment of an early termination fee and sufficient notice to the other party.

d. Transition: Upon expiration or termination the parties may provide for a transition phase during which the service provider would continue to provide services for a particular period of time, train certain persons designated by the customer, provide documentation of the processes, and do other acts that are required for a smooth transition. The customer would insist on having the right to purchase the assets and infrastructure that are being used to provide the services and also have the right to employ the persons on the team that were providing such services.

e. Effect of Termination: The agreement should also specify the effects of termination on various aspects such as payment of outstanding fees, escrow, IP and confidential information, and current work orders.

## Governing Law and Jurisdiction

Parties would prefer to have the agreement governed by the laws of, and be subject to, the courts in their respective home countries. As a compromise, they may agree to have laws of a third foreign country govern the agreement. Parties have usually

chosen the laws of England, as the legal system is well established. However, there exist conflicting views as to whether an agreement can be governed by the laws of a country that has no nexus with the parties or the agreement. Hence, it is advisable for the governing law to be that of home country of one of the parties. Parties could have a combination in which certain clauses are governed by the laws of the customer's country and the other clauses are governed by the laws of the service provider. It has been observed that such contracts are generally governed by the laws of the customer's country.

- **Alternate Dispute Resolution (ADR)**

  Parties resort to alternate dispute resolution (ADR) mechanisms such as arbitration rather than resorting to the traditional legal systems due to the high cost and time required for resolving disputes. Arbitration is usually held in accordance with the Rules of the International Chamber of Commerce (**ICC**) or the London Court of International Arbitration (**LCIA**) for international commercial arbitration. More recently, parties subject themselves to arbitration in the Singapore International Arbitration Centre (**SIAC**).

- **Enforcement of Foreign Awards and Judgments**

  It has to be ascertained the most effective way to enforce the award or decree against the losing party. Such enforcement can occur within or outside of India.

  a. Enforcement of Foreign Awards in India: India is a signatory to the New York Convention on The Recognition and Enforcement of Foreign Arbitral Awards, 1968 (NYC). Thus, if a party receives a binding award with respect to a commercial dispute from a NYC signatory country which is recognized as a reciprocating country by India, the award would be enforceable in India. However, the courts in India may refuse to enforce a foreign award under certain conditions such as incapacity of the parties, noncompliance with the agreed arbitration procedure, nonadherence to the principles of natural justice, among others. Enforcement may also be refused if the subject matter of the award cannot be settled upon by arbitration under the laws of India or if the award's enforcement would be contrary to the public policy of India.

  b. Enforcement of Foreign Judgments in India: A foreign judgment may be enforced by filing a suit upon judgment under section 13 of the Code of Civil Procedure, 1908 ("CPC"); or by proceedings executed under Section 44A of the CPC, provided that the judgment is rendered by a court in a "reciprocating territory." A "reciprocating territory" is one that is deemed by the Government of India to be a "reciprocating territory" under section 44A of the CPC. For instance, the U.K. has been deemed by the Government of India to be a "reciprocating territory," while the U.S. has not been considered as such.

  However, a foreign judgment cannot be enforced in India under certain circumstances, such as when the judgment has not been pronounced by a court of competent jurisdiction, the decision is not on the merits of the case, the principles of natural justice have been violated, or when the judgment violates public policy.

  c. Enforcement of Awards and Judgments Outside India: To determine the modalities for the enforcement of an Indian award or judgment in a foreign jurisdiction, it is necessary to examine the procedural laws of the foreign country in question.

- **Applicability of Foreign Laws**

  Offshore outsourcing in a global economy exposes companies to the laws of the jurisdictions in which they conduct business. Non-compliance with foreign laws could expose a company to significant liabilities. For example, an Indian call center offering outbound services to a US company could be required to comply with certain US regulations, such as telemarketing rules and abide by a "Do-Not-Call" laws. Recently six Hyderabad-based companies, including Goldstone Technologies and CallWorld Technologies, with an aggregate estimated capacity of over 500 seats, decided to shut down or are in the process of winding up operations. Industry sources reveal that companies are now starting to take insurance cover for calls that accidentally fall in the "Do-Not-Call" Registry.[27] Further, BPO providers should be aware of laws and particular industry-specific regulations that have implications on outsourcing transactions. For example, in the insurance industry, US state laws require persons providing administrative functions, including claims administration and payment, marketing administrative functions, and coverage verification to obtain Third Party Administrator Licenses to carry out such activities. This could include whether, and when, any actions involving governmental authorities must occur, such as approvals or notices and whether there exist regulatory requirements specific to the outsourced services that apply to the project. The advantages of outsourcing can come at a price. The lack of complete understanding of the potential legal, regulatory, and business pitfalls in the heavily regulated industries can make outsourcing a minefield, exposing companies to regulatory sanctions and legal liability.

  It is important that the parties involved in the outsourcing transaction work together to evaluate their risks and ensure that the burden of compliance is balanced.

## Going Forward

Presently, the BPO industry is in an evolutionary phase. The estimated growth of this sector is positive, yet in order to ensure that the sector moves in a favorable direction it is important that the different problems and hindrances that have surfaced are handled properly. Offshore outsourcing gives rise to several consequences, including the loss of jobs in the country that outsources services to a foreign country. As a result, the recent boom in the BPO space has triggered an anti-outsourcing wave in countries such as the US However, the spate of anti-outsourcing bills is due more to the depressed economy than any specific anti-outsourcing backlash, according to the industry leaders, bureaucrats, and technologists at the NASSCOM ITES-BPO strategy summit held in June 2003.[28] According to ASSOCHAM, in the short term the Indian ITES will experience a minimal to moderate impact even if these bills become law in certain US states. Certain states are considering restricting outsourcing software services in the telecommunications and defense industries to foreign companies.[29] However, despite all the challenges, the Indian BPO service providers are extremely optimistic over future industry prospects.[30] At this juncture, it is important that the interest level and the positive attitude are maintained. In spite of the problems that have emerged in the BPO sector, companies are expected to increase their spending on BPO to capitalize on the advantages it offers. Overall, BPO revenues will hit $146 billion in 2008, according to Forrester estimates.[31] On this positive note it would be appropriate to state that the BPO industry is here to stay and mature soundly. ■

[27] http://economictimes.indiatimes.com/cms.dll/html/uncomp/articleshow?msid=198189, visited on September 25, 2003.
[28] http://www.thehindubusinessline.com/bline/2003/06/13/stories/2003061301370700.htm, visited on September 23, 2003.
[29] http://www.assocham.org/publications/bulletin0703.pdf, visited on September 23, 2003.
[30] http://www.blonnet.com/2003/07/06/stories/2003070601530100.htm, visited on September 23, 2003.
[31] http://www.nwfusion.com/news/2003/0902bpohype.html, visited on September 25, 2003.