Twist in the fairy tale. Will India continue to shine?

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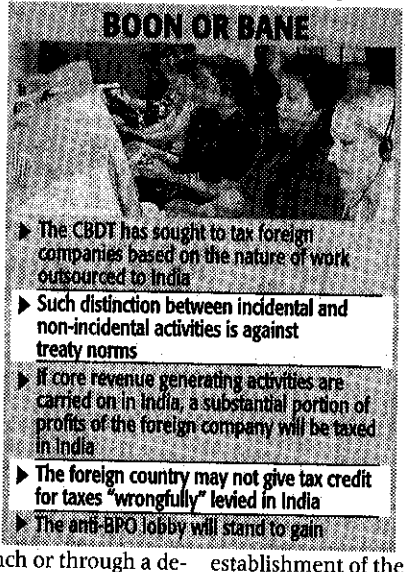
IT SOUNDS straight out of Ripley's 'Believe it or not'. The Central Board of Direct Taxes (CBDT) has issued a circular exempting any income attribution in India in the hands of foreign companies that outsource incidental work to service centres in India. Such instances include procuring orders with customers abroad, answering sales-relating queries from abroad and dissemination of relevant information to potential customers abroad. If no income is attributed to the foreign company in India, the foreign company is not subject to any Indian taxes. At first glance, it appears India will continue to shine in the BPO segment.

"India — the destination of the new millennium," which is how the ministry of tourism describes India, could be modified as, "The one and only destination for all your BPO needs." The Indian BPO industry is expected to grow at an annual compounded rate of close to 60% next year. The expected growth rate would take the industry size to $4bn by end-'04.

Unfortunately, unlike in fairy tales, this future outlook might have a tragic end. The CBDT circular could result in high-value-ended work being sent to Ireland or Philippines and Indian service providers could be left holding only the telephone instruments and catering to low-level, bottom of the chain, BPO assignments.



In the context of BPO operations, here is some technical jargon on when and how India can tax a foreign company and what the CBDT has sought to do. A foreign company is treated as having a permanent establishment (PE) in India under Article 5 of the relevant tax treaty and under Section 9 of the Income Tax Act, 1961, if the foreign company carries on business in India through a branch or through a dependent agent that "habitually" exercises an authority to conclude contracts or regularly delivers goods or merchandise or "habitually" secures orders in India on behalf of the foreign company. In such a case, the profits of the foreign company, to the extent they are attributable to the PE in India, are subject to tax in India.

The CBDT in its circular, has exceeded the norms set by treaty and domestic laws. As reported by ET earlier, CBDT has based the tax incidence in the hands of the foreign company, depending on the nature of work done by the service provider in India.

KR Girish, partner, RSM and Co, chartered accountants, points out, "The domestic tax laws and treaty laws do not contain concepts like core business generating activities. All activities performed in India are treated at par and profit attribution, if any, is determined irrespective of the nature of work performed."

The CBDT in its circular admits that if the price charged by the PE is at an arm's length or at a fair price, no income can accrue or arise in the hands of the foreign company. But when it comes to "core generating activities" carried out in India for a foreign company, a different stand is adopted.

The circular specifies, "On the other hand" where a foreign company outsources the whole or part of its "core revenue generating business activities" to an IT-enabled entity (service provider) in India, such as the services of a travel agent, software developer, software maintenance, investment consultant, debt collection service etc and the Indian entity renders the services directly to the customers abroad or through the foreign company, a "considerable portion of the profits of the foreign company from its customers abroad would be attributable to the activities carried on by the Indian entity. Hence, such profits would be subject to tax in India."

Nishith Desai, founder, Nishith Desai Associates states, "Under treaty provisions, if the price charged by the service provider in India is at arm's length, this pricing itself would subsume the entire profits attributable to the PE in India and the foreign company cannot be taxed in India." This is exactly what the Vijay Mathur committee had told the CBDT in its final report.

According to Nitin Karve, partner, Bharat S Raut and Co, chartered accountants, "The circular appears to suggest that the CBDT will move away from the arm's length concept in determining the profits of the service provider which is the permanent establishment and performs core business activities. It is imperative that this matter is clarified urgently."

There is another twist, if one may say so, to this entire issue. Mr Girish points out, "If equipment is provided to an independent third party, and this party carries out activities in the nature of travel agency or software maintenance, the tax authorities could contend that the equipment constitutes a PE."

Remember the demands running into several crore raised on a clutch of CRS companies in India in late 1990s? As was duly reported by ET then, these demands were raised on a clutch of computer reservation companies, such as Galileo, Abacus, Amadeus and Saber.

The reason: travel agents in India were provided with computers, modems and other equipments. Tax authorities held that such equipment constituted a permanent establishment of the foreign company in India. A fair portion of the profits of the foreign companies was held attributable in India and subject to Indian tax. These cases are still pending in various stages of appeal.

Says Mr Karve, "A prospective foreign company weighs its cost savings from outsourcing to India against the tax costs in India. If a considerable portion of the profits of the foreign company are sought to be taxed in India, it may cease to be cost effective to send work to India."

Balance the rate of 35.8%, which would be levied in India if a subsidiary is treated as PE in India as against a prevailing tax rate of just 12.5% in Ireland.

And Ireland has not attempted to bring the foreign companies to tax by hook or by crook. Now what would foreign companies prefer? Ireland or India for high value added work? Other countries like Philippines and China, two other strong competitors also provide software technology parks, India is not the exception. With this circular, foreign companies are in for a double whammy.

Tax treaties provide for a credit mechanism whereby the taxes borne in the host country (India) are given a credit in the home country (US), but in such a scenario such credit is unlikely. Explains Mr Desai, "The wrongful attribution of profits in India will result in the IRS not accepting the same. The foreign company is unlikely to get a tax credit for taxes paid in India against its US taxes." Mr Desai, who also has an office in Silicon Valley, points out that the anti-BPO lobby will now stand to gain.