

Captive BPOs won't be taxed in India

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BANGALORE: Companies in Silicon Valley, California, that were highly perturbed by a recent circular of the Central Board of Direct Taxes (CBDT) relating to taxation of [BPO activities](#) carried out in India, have breathed a sigh of relief.

A J Majumdar, joint secretary, Foreign Tax Division, CBDT, in a telecon address to attendees during a recent seminar in Palo Alto, said, "India does not intend to digress from internationally accepted principles of international law, as enshrined in the OECD Model Tax Convention, nor the tax treaties it has entered into."

Mr Majumdar also clarified various doubts that were raised by participants from several US-based companies. The seminar was organised by San Jose State University and Tax Executives Institute.

Nishith Desai, advocate, was the co-chairman and one of the panelists at this particular session. An overview of the session has been provided exclusively to ET, by Nishith Desai Associates, international legal counsellors.

One of members at the seminar shared his experience, where a demand notice was served on the basis of the circular. The [tax](#) officer contended that the R&D subsidiary in India constituted a permanent establishment (PE), as its activities here were core activities. Thus, the foreign company was held to be taxable in India.

Mr Majumdar clarified that the circular cannot be used to create a PE, when there is no PE in India.

As per treaty laws, India cannot tax the business income of a foreign entity, unless that entity has a PE in India. In the BPO context, a captive subsidiary in India can be treated as a PE if it is a dependent agent of the foreign parent for example, when it concludes contracts for its foreign parent.

Mr Majumdar emphasised that, An Indian subsidiary is a separate legal entity liable to Indian taxation on account of it being a tax resident of India. A subsidiary would not, by itself, be a PE of its foreign parent, unless it has the authority to conclude contracts on behalf of its foreign parent. Similarly, a sub-contractor would not automatically constitute a PE.

Mr Desai said, Over 95% of the work done by captive subsidiaries in India is on a sub-contract basis it is under a service contract. The major concern here was whether the Indian subsidiary engaged in software development or maintenance would be regarded as a PE, leading to attribution of considerable portion of the global profits in India and tax in the hands of the foreign company. This worry is now put at rest, although a formal clarification having a binding effect is desirable.

In cases where a subsidiary is actually a PE of the foreign parent, Mr Majumdar clarified that the arm's length concept of pricing would not be ignored. In such instances, Article 9 of the relevant treaty, which relates to associated enterprises, would be followed. It will be applied to determine whether or not the Indian subsidiary has been compensated at an arm's length, he added.

Mr Desai explained, If the transaction with the Indian subsidiary, that is a PE is at an arm's length, under treaty laws, no further profits can be attributed in the hands of the foreign parent.

The CBDT circular had caused a lot of confusion as it stated that if core activities are carried out in India by an IT-enabled entity, that is the PE of the foreign company, then a considerable portion of the profits of the foreign company would be attributed to the activities performed by the entity in India. The foreign company would thus be subject to tax in India.

Companies wishing to outsource to India were upset over the use of words such as attribution of a considerable portion of profits, without there being clarity as to the mechanism for such attribution. There was also a fear that a captive subsidiary would be construed as a PE and the foreign company would be subject to taxes in India.

Mr Majumdar reassured the attendees that if the actual cases of misapplication of the circular are brought to his notice, the department would be happy to look into these cases. Most companies based in Silicon Valley want the CBDT to issue a follow-up circular to settle the doubts of companies that wish to outsource to India and provide them the much needed certainty.