

Tax Hotline

August 10, 2004

OUTSOURCING ENTITIES TO GET A BREATH: CIRCULAR ON CORE - NON-CORE ACTIVITIES WITHDRAWN

The Central Board of Direct Taxes ("CBDT") in India has issued a **draft circular** on August 9, 2004 on the tax regime for Business Process Outsourcing ("BPO") units. The draft circular ("**Circular**") is open for public comments. The 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 Permanent Establishment ("**PE**") as per the provisions of Article 5 of the Double Taxation Avoidance Agreement ("**DTAA**") between India and the other country where such entity is a resident. This Circular withdraws the **Circular No. 1** issued by the CBDT in January 2004, which had raised the controversy on taxation of BPO units in India.

This Circular has been issued after various representations made by industry representatives to the Finance Ministry / CBDT, pursuant to the uncertain environment created by the Circular No. 1. As a matter of background, the Circular No. 1, which was issued for clarifying taxation of Information Technology enabled BPO units in India, actually ended up creating an apprehension and uncertainty for foreign companies outsourcing operations to India. This uncertainty arose on several counts: ambiguity in the meaning of core and non-core activities; use of words such as 'attribution of a considerable portion of profits' without providing clarity on the mechanism for such attribution and fear that a captive subsidiary may be construed as a PE leading to foreign company becoming subject to taxes in India.

The Circular now states that where the foreign entity has a PE in India, only such amounts as are attributable to the business carried out by the foreign entity in India, would be subject to tax in India. For this purpose, the amount attributable to tax in India would be the amount determined on an arm's length basis, *i.e.* the amount determined in a situation where the Indian BPO units were dealing with an entity other than an 'associated enterprise' and where the transaction is based on an arm's length price. For this purpose, the meaning of arm's length price would be the same as defined in Section 92F(iii) of the Indian Income Tax Act, 1961, *i.e.* the price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions.

Once the CBDT receives comments on this Circular, it may issue a final circular and with effect from that date, the old Circular No. 1, 2004 will be withdrawn.

Source: Draft Circular No: /2004 (F.No.500/67/2003-FTD), dated August 9, 2004

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