

Tax Hotline

September 29, 2004

OUTSOURCING - FINAL TAX CLARIFICATION ISSUED

The dust seems to be settling in on the controversies surrounding taxation of Business Process Outsourcing ("BPO") operations in India. On September 28, 2004, the Central Board of Direct Taxes ("CBDT") in India issued Circular no. 5 of 2004 ("Circular") clarifying the taxation of foreign companies having BPO units in India. The Circular is in line with the draft circular dated August 9, 2004 that was issued for public comments. With the issuance of the Circular, the controversial circular no. 1 of 2004, which differentiated between core and non-core/incidental services, stands withdrawn with immediate effect.

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 country of residence of the foreign company. As per the 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. For this purpose, the meaning of arm's length price would be the same as defined in Section 92F(ii) of the Indian Income Tax Act, 1961, ("ITA") 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 ITA.

Laudatory in its intent, the 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 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.

Source: Circular No. 5 /2004 (F.No.500/67/2003-FTD), dated September 28, 2004

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