

Business Process Outsourcing and PE Issues

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Today, outsourcing non-critical and routine business processes to an offshore location is a crucial part of decision-making for multinational enterprises in order to save costs and ensure timely delivery. Offshore outsourcing derives its power by marrying technology-enabled services with labour and cost arbitrage. The idea is to move a job or function from a high-cost to a lower-cost location outside the country. The magnitude of the resulting cost savings is just too compelling to ignore. In order to cut costs in this depressed market, business entities in various sectors, including banking, financial services, telemarketing, insurance, HR, to name a few, outsource their back office operations to cost-effective countries. India, the Philippines and Malaysia are a few of the countries that have earned a name as cost-effective and efficient destinations.

In order to improve their customer contact service levels and reduce costs for their operations, many companies have set up subsidiaries in India for housing an offshore centre to carry out certain back office operations or have entered into arrangements with third party service providers. These operations include back office processes such as call centres, e-mail-related services, HR-related services, payroll processing, equity research, image processing, accounting services, and so on. Generally, a service fee is paid to the Indian service provider. For instance, an insurance company could outsource to India back office processes such as replying to new business quotations, follow-up for collection of premiums, updating customer details, processing changes to contract details, calculating

benefits and payouts, management of customer service relationships and head office support services such as finance and human resource. A typical Business Process Outsourcing (BPO) structure can be diagrammatically represented as shown in Figure 1.

However, the very nature of the BPO activities raises issues related to whether the Indian operations could constitute a Permanent Establishment (PE). Associated issues of transfer pricing and attribution of profits, and eligibility to claim tax holidays in India also arise.

PE issues

Generally, PE is understood as that degree of economic penetration that, according to the agreement between the treaty partners, justifies a nation in treating a foreign person for income tax purposes in the same manner as domestic persons.

It would be pertinent to note that call centres and back office activities are a recent phenomenon and thus there is not much jurisprudence or commentaries of experts in the field of international taxation regarding application of the PE concept to such activities. Therefore, whether a BPO centre would constitute a PE of its foreign parent/customer would have to be based on the application and interpretation of the PE concept in general, read with the commercial realities of such back office activities.

Basic PE test

Prima facie since the activities of a BPO centre are to carry out the back office activities of a foreign entity, it can be alleged that the foreign entity has a fixed place of business in India. Generally, the foreign entity would like to ensure the quality of deliverables by retaining a certain level of control over the BPO centre which is typically done by having control over the staffing and operations of the Indian service provider. Thus, it could also be alleged that the BPO facilities are at the disposal of the foreign entity and hence constitute a place of business of the foreign entity in India.

Agency PE test

A BPO centre typically functions as per the detailed instructions provided by the foreign entity. In such

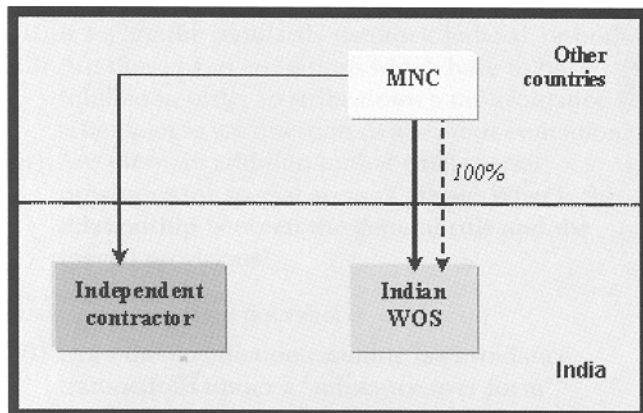


Figure 1: BPO scenarios

situations, the determining factor for ensuring that the independent-agent status is not breached would be whether the detailed instructions are in relation to the results to be achieved as opposed to the means of accomplishing them.

The phrase 'authority to conclude contracts in the name of the enterprise' is equally important in a BPO scenario if the service provider has an authority to conclude binding contracts on behalf of the foreign entity. Even an authority by estoppel could be regarded as an authority to conclude contracts. In a typical BPO scenario, a customer interacting with the employees of the call centre is given the impression that he is interacting with the foreign entity itself. Further, in some situations, varied services rendered by the employees of the BPO service provider could culminate in binding contracts for the foreign entity. This could expose the foreign entity to the risk of having a PE in India.

Attribution issues

In the event that the Indian BPO centre is regarded as a PE of the foreign entity in India, profits of the foreign entity would be taxable in India to the extent that they are attributable to the operations of such PE. Presently, the attribution rules under the domestic tax law of India confer a greater level of discretion on the income tax authorities.

Tax exemptions

Realising the vast economic potential of this sector, the Indian Government has conferred various tax incentives to BPO centres set up in certain designated areas and subject to fulfilment of certain conditions. The export of the IT-enabled services industry currently enjoys a 100 per cent tax holiday. This will last until 31 March 2009.

Here it would be important to note that if at the assessment level, the Indian tax authorities make an upward revision to the transaction value between the Indian service provider and the foreign entity on account of transfer pricing, such additional income would not be eligible for the tax holiday in the hands of the Indian BPO centre. Thus, transfer pricing issues need to be adequately addressed.

Conclusion

With low labour costs, a large pool of skilled and English-speaking workers, favourable government policies and incentives, India has emerged as the key outsourcing hub for various business processes and information technology enabled services. However, while formulating the outsourcing strategy, multinational enterprises should take into account PE exposure and transfer pricing considerations.