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PRACTICAL ASPECTS & INDIAN PERSPECTIVE

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# CROSS-BORDER OUTSOURCING

Session summary: **Shefali Goradia, BMR & Associates LLP**

Panel discussion: **Pinakin Desai, Ernst & Young**

**Padamchand Khincha, H.C. Khincha & Co**

# SCOPE AND CONCEPT

- Business phenomena of outsourcing certain business functions
- Could be to a *third party* service provider or a *group entity*
- Could outsource *core* as well as *non-core* functions
- For emerging economies in-sourcing has become an avenue of *employment* generation, increasing investment in *infrastructure* and building up of *foreign exchange reserves* – India has become an outsourcing hub
- Tax typically not the primary driver, though resultant tax costs / savings could be an important consideration

# 1. BUSINESS PURPOSE TEST

## ➤ Commercial imperatives v/s tax saving motive

- Driven by business need; backed by underlying commercial imperatives
- Outsourcing of “core business” – will this satisfy the business purpose test
- Not necessarily be driven by tax saving, but may have a tax saving component – awareness about the tax incentives provided in the source state is important
  - *Incentives:* Export related; Investment linked; Location based; Activity based; Indirect tax exemptions

## 2. PERMANENT ESTABLISHMENT

### ➤ Fixed place PE

- Whose business? – Service provider's or service recipient's?
- Corporate entity form of the service provider (captive entity / subsidiary) respected, unless found to be sham – fixed place PE risk only if the captive entity is “at the disposal” of the foreign entity
- Additionally, ‘preparatory and auxiliary’ exception may apply in some cases

### ➤ Agency PE

- Legal and economic dependence necessary
- Key controversy areas:
  - Participation in negotiations
  - Conclusion / renewal of standard contracts
  - Sales contracts vs contracts for internal / back-office activities

### ➤ Service PE

- Potential exclusions
  - Provision of technical services
  - Deputation of employees – Transfer of legal vs economic employment
  - Safe harbour for stewardship activities – Landmark Morgan Stanley ruling



### 3. ATTRIBUTION OF PROFITS

(1/2)

#### Concept

- Attribution of profits – determined based on the extent of activities in the source country
- Hypothetically separate entity; attribution based on FAR
- Complete independence (AOA) vs restricted independence – debate continues

#### Common issues

- Deduction of general H0 expenses allocable to the PE
- Force of Attraction Rule in some treaties

### 3. ATTRIBUTION OF PROFITS

(2/2)

- Attribution in case of DAPE – additional consideration
  - **Fictional character** of the dependent agent and difficulty in attributing IP and entrepreneurial risk to the PE
  - No additional profit over and above arm's length remuneration of agent itself?
- Principle on attribution laid out by the SC in the case of Morgan Stanley
- Impact of arbitrary methods of attribution applied by Indian revenue authorities
  - Rollys Royce Plc vs DDIT – profits apportioned to activities undertaken in India on arbitrary basis
  - Convergys Customer Care Management Group Inc - profits attributable to Indian PE on the basis of an ad-hoc proportion of Indian profits after applying global profitability percentage to India revenues

# 4. TRANSFER PRICING

- Related parties: arm's length price determination based on FAR
  - OECD guidelines generally applied
  - Cost – plus method appropriate?
  - Higher mark up justified for R&D functions?
  - Growing uncertainty on subjects such as
    - Location savings
    - Economic vs legal ownership of intellectual property developer
    - Economic vs contractual allocation of business risk
  - Other issues
    - Issues in business restructurings
    - Difficulty in securing corresponding adjustments
    - Lack of clarity / unavailability of comparables
    - Dispute resolution - MAP; Arbitration/APAs/Safe harbours relatively new
    - Differing interpretation across jurisdictions



## 5. TAX WITHHOLDING

- Most residence countries grant credit, subject to certain conditions
  - Controversy on characterization – difference in view between countries
- Service fee – Physical performance vs deemed source rule; only specified service categories covered
- Royalty – Exemption in few countries, subject to conditions
- Expatriate salary – Employer to withhold tax if stay exceeds threshold
- Material role of tax treaties in planning outsourcing arrangement
- Anti-abuse provisions may trigger (higher) withholding in some countries if:
  - outsourcing entity not compensated at arm's length
  - outsourced entity is resident in a country with no tax treaty or no EOI
- 9 ➤ India: non-resident to withhold tax on service fee to Indian service provider

## 6. ANTI-OUTSOURCING MEASURES (1/2)

- Multinationals have ability to allocate resources and activities between jurisdictions – tendency to retain income in captive service provider in low tax jurisdiction
  - Relatively easier to shift e-commerce activities not requiring human intervention or intellectual property related income
- Issue is double-dipped – where affiliate enjoys tax incentive in source country and parent enjoys participation exemption in resident country
- These issues may be addressed in some jurisdictions through one or more mechanisms (not prevalent in India currently)
  - **Disincentives under domestic tax laws**
    - **Disallowance of expenses** paid to group companies established in low-tax jurisdiction
    - **Limitation on participation exemption** with regard to dividends and capital gains arising from subsidiaries located in low-tax jurisdiction or enjoying special incentives
    - **Disincentives arising due to restructuring** of operations

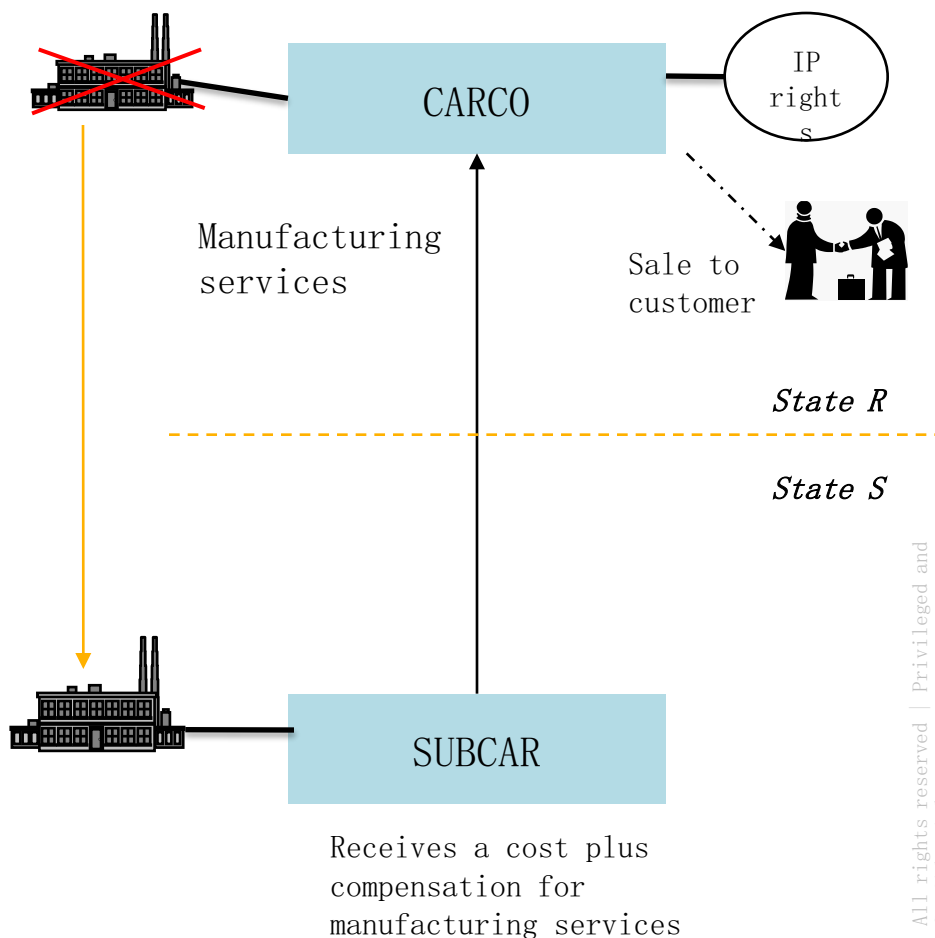
## 6. ANTI-OUTSOURCING MEASURES (2/2)

- **Imposition of exit tax** - justified only where major intangibles and risks are transferred hence, the recipient receives an entrepreneurial return
- **Application of CFC regime** - taxation of profits of foreign subsidiary located in a low tax jurisdiction where location is not justified by economic reason

# CASE STUDIES

# CASE STUDY 1: OUTSOURCING MANUFACTURING

- CARCO is a resident of State R. It manufactures and sells branded automobiles
- SUBCAR is a subsidiary of CARCO and is a resident in State S
- CARCO has transferred the manufacturing activity to SUBCAR. SUBCAR assembles cars from parts owned and supplied by CARCO. Parts remain the property of CARCO. Once assembled, cars are shipped back to State R and distributed by CARCO
- SUBCAR is compensated by CARCO based on the cost plus method
- CARCO keeps IP rights (brand) and designing products
- SUBCAR does not bear any significant risk and does not use significant IP rights



**Alternative scenario:** parts and assembled cars are the property of SUBCAR

# CASE STUDY 1 – IS THERE A PE?

## 1. Fixed place PE

- Separate legal status of subsidiary to be respected
- Business activity test not satisfied
- Right to disposal not satisfied
- *However, maintenance of stock of goods on the premises of the toller, which is owned by the foreign entity and processed by the toller, might lead to a fixed place of business of the enterprise (unless covered by exclusion clause)*

## 2. Agency PE

### Legal dependency

- Does CARCO exercise comprehensive control and give detailed instructions ?
- Does SUBCAR have own assets / employees / responsibilities?
- Cost plus remuneration may be seen as “reimbursement of all expenses”

### Economic dependency

- Appears to act on behalf of one principal
- SUBCAR does not bear any significant risk/financially dependent on CARCO

### Activity criterion

- No authority to conclude contracts

Will conclusions on business presence under Indian domestic law be different?

- Distinguish between PE attribution and ALP payment to I Co
- Cost plus or TNMM method
  - Largely acceptable when contractor functions are routine, non core, repetitive, standardized, low capital, vocational skill, etc.
  - FAR of principal comprise of strategic decisions, designs, technology, brand development / maintenance, market risks: sales, distribution and inventory, finance, etc.
  - Contractor risks are reimbursed or insulated
  - Scope for competitive players in source or third country jurisdiction
  - Business model emerging as popular amongst competitors as usual trade practice offering no scope for super profit

## Factors which influence ALP determination

- ALP is primarily influenced by FAR of respective party
- In case of BR, evaluate respective FAR pre and post BR
- Weigh respective bargaining strength; but, ignore undue exploitation
- Weightage of licensed know-how, or in-house funding manufacturing skill or training
- Comparison yardstick is analysis of arm's length third party
  - Not necessarily revenue unfriendly
- Single customer dependence v. assured business

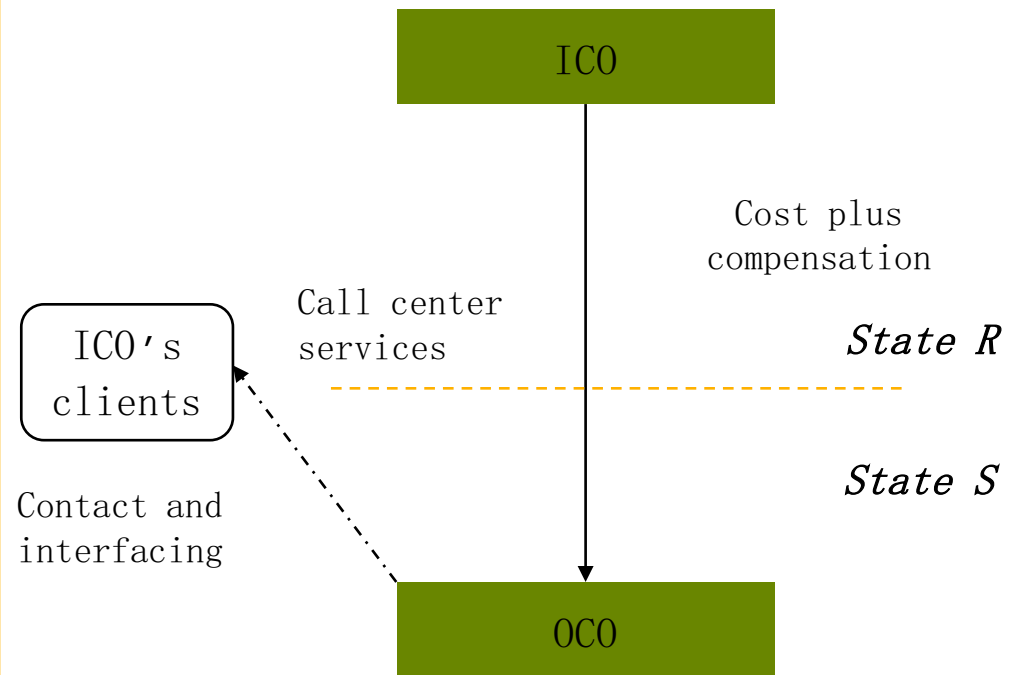


## On-going struggles

- Whether a case of service provider or highly integrated entrepreneur involving IP or skill
- Factors of Complexity
  - Sole plant in India
  - Nearness to market or source of supply in India
  - Integrated intangibles
  - Exit compensation, BR costs
  - Exclusive access to or control over factors of specific location savings
  - Market compulsion

## CASE STUDY 2: OUTSOURCING SERVICES

- ICO, resident of State R, provides insurance services
- OCO, which is a State S subsidiary of ICO, provides call center services to ICO
- OCO's services include maintenance of client database, interfacing with customers, providing information, power to negotiate with ICO's clients under its instruction and within pre-defined parameters
- Clients sign contracts with ICO
- OCO is compensated by ICO based on the cost plus method



# CASE STUDY 2 – IS THERE A PE?

## 1. Fixed place PE

- Separate legal status of subsidiary to be respected
- Business activity test not satisfied
- Right to disposal not satisfied

## 2. Agency PE

### Legal dependency

- Does ICO exercise comprehensive control and give detailed instructions ?
- Does OCO have own assets/employees/responsibilities?
- Cost plus remuneration may be seen as “reimbursement of all expenses”

### Economic dependency

- Appears to act on behalf of one principal
- OCO does not bear any significant risk/financially dependent on ICO

### Activity criterion

- Limited authority to conclude contracts

Will conclusions on business presence under Indian domestic law be different?

# CASE STUDY 2 – TRANSFER PRICING

- Issues
  - Arm's length remuneration for OCO
- Nature of contributions by the call center
  - Contracts, conduct, comparability factors
  - Comparable transactions
  - Pricing: most appropriate method
  - If relevant sales function or performance indicators:
    - Cost plus method the most appropriate method?
- Outcome should be the same if performed by third party