Technology and Telecommunications

By Richard E. Andersen[*]

The (Un?)Happy Outsourcer: Challenging Regime, Developments Underscore Ongoing Tax Reform Imperative for the Indian Market

Introduction

It has become a truism in the first decade of the 21st century that the hotbeds of cross-border investment are China and India. For many reasons—some of which the two countries have in common, and others that differ markedly—the literature of international investment speaks of the two markets in tandem when discussing trends in where multinationals are going—and growing. And yet, in spite of the popular tendency to treat India and China as the conjoined twins of cross-border investment, they are in fact experiencing very different capital inflows: in 2005, China reportedly attracted over $72 billion in inbound investment—nearly five times the figure for India.[1]

An earlier column explored the salient aspects of the Chinese tax system as it (mostly) contributes to—and (occasionally) impedes—inbound investment by multinationals from other countries.[2] This column addresses the corresponding provisions of India's tax regime, and concludes that those provisions can act as a significant impediment to inbound investment and a brake on the country's development.

Overview of the Indian Tax System[3]

India has a federal system in which both the national government and the country's 29 states administer separate tax regimes.

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National Level

Domestic companies (those that are either incorporated in India or declare and pay dividends, within India, out of their Indian taxable income) pay a basic corporate income tax of 30 percent, plus a 10-percent surcharge and a two-percent education levy, yielding a combined effective rate of 33.66 percent. Subject to any contrary provisions of an applicable income tax treaty, branches of foreign companies pay a 40-percent basic rate, plus a 2.5-percent surcharge and the education levy). In addition, all companies are subject to a minimum alternative tax that applies to companies having a regular tax liability that is less than 7.5 percent of profits, those profits are treated as the entire taxable income and taxed at a 7.5-percent basic rate (plus the applicable surcharge and education levy). All companies are also liable to a one-percent tax on the aggregate net value of their taxable assets in excess of 1.5 million rupees. In addition, an increasing number of specified services are subject to a 10-percent service tax.

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State Level

Historically, the state tax system in India has been marked by complexity and uneven administration. The country attempted a root-and-branch reform in 2005 through the introduction of a value-added tax system designed to replace many of the existing state levies; but this initiative has encountered resistance and has not been fully implemented as of this writing.

Taxing Jurisdiction

For resident Indian companies, tax is imposed on worldwide income less allowable business deductions, such as for materials, compensation, repairs, insurance, royalties, interest, dividends, rents, certain taxes and depreciation. In the case of a nonresident company, the taxable amount is the portion of the company's profits properly attributable to an Indian permanent establishment. For many years, the Indian tax authorities have taken an unusually expansive view of both the definition of "permanent establishment" and of the rules for attributing profits to such a nexus. Some developments during the past two to three years suggest that this trend continues.

Developments Regarding Taxable Nexus

Local Manager as Permanent Establishment

India's advance ruling authority (AAR) held in *Sutron Corporation*[4] that the presence of a country manager in India may constitute its employer's permanent establishment in India.[5] In this case, Sutron, a U.S. corporation, contracted with the government of the province of Andhra Pradesh to supply goods for erecting remote stations, as well as local materials and services. The full range of activities leading up to the execution of the contract—including the preparation and execution of proposals and the filing of bidding forms—took place in the United States. However, Sutron submitted these documents to the provincial government through its India-based country manager, who also signed the contract.

Sutron claimed that its country manager was an independent consultant and not an employee, and that consequently he was acting as an independent agent within the normal scope of his own business and therefore did not constitute an Indian permanent establishment of Sutron. The AAR noted that the manager was a paid agent who collected market information and invitation tenders on behalf of, and furnished information to, Sutron; submitted bid proposals to respective customers for Sutron; and executed contracts for the company. Hence, it held that the country manager's home was a fixed place from which business of the U.S. company was at least partly carried on.

Business Process Outsourcing (BPO) Profits

The linchpin of India's thriving information technology industry has long been the outsourcing of business processes to take advantage of India's well-educated and technically proficient workforce, the relatively low cost structure in which they operate, and the substantial time zone leverage the country provides to Western companies. Considering the importance of this "golden goose" to India's economy,

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application of U.S. tax treaties, the Deputy Commissioner (International), Large and Mid-Size Business Division acts only with the concurrence of the Associate Chief Counsel (International).

[2] Rev. Proc. 2006-44, IRB 2006-44, 800.

[3] Rev. Proc. 2002-44, IRB 2002-26, 10.

[4] Rev. Proc. 2002-52, IRB 2002-31, 242.

[5] Rev. Proc. 2006-54, IRB 2006-49, 1035.

[6] As noted in Section 2.03 of Rev. Proc. 2006-54, the U.S. Competent Authority is permitted to initiate competent authority negotiations with its foreign counterpart in any situation that it believes is necessary to protect U.S. interests. Thus, the U.S. Competent Authority's scope of authority is not necessarily predicated on the receipt of a taxpayer request for assistance.

[7] Rev. Proc. 2006-54 is limited in its application with respect to disputes that may arise with respect to the application of a U.S. treaty. Rev. Proc. 2006-23 is applicable in regards to any disputes that may arise in relation to an U.S. possession tax agency.

[8] Any request submitted prior to the issuance of a written communication from the IRS will generally be denied as premature.

[9] *See also* Rev. Proc. 2007-7, IRB 2007-1, 227, which updates the IRS's international "No Rule" list. Section 3.02(5) provides the IRS will not rule with respect to any area where the same issue is the subject of taxpayer's pending request for competent authority assistance under a U.S. tax treaty. Interestingly, Rev. Proc. 2007-17, IRB 2007-4, provides that the IRS *will* entertain a request for a Prefiling Agreement for an issue that is the subject of a previously submitted request for competent authority assistance.

[10] Including an IRS Appeals settlement reached through the arbitration procedures.

[11] A taxpayer is permitted to request a prefiling conference with the offices of the Chief of IRS Appeals and the U.S. Competent Authority to discuss the Simultaneous Appeals procedure.

[12] The U.S. Competent Authority is also permitted to request IRS Appeals' involvement if it is determined that such involvement would facilitate the negotiation of a mutual agreement or otherwise serve the interest of the IRS.

[13] IRS Appeals normally considers the hazards of litigation in settling a case. This process allows IRS Appeals to determine the probability that the courts will agree with the IRS determination, and then use that probability to reduce the proposed tax liability. *See* Reg. §601.106(f)(2) Rule II; IRM 1.2.1.8.4.

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the country's tax authority has occasionally taken a surprisingly aggressive view on the permanent establishment consequences of such BPO activities by nonresident companies. In early 2004, for instance, the government proposed a circular on taxing such activities between nonresident companies and their related Indian outsourcing arms that were widely criticized as inconsistent with international tax jurisdictional norms in general and India's network of double tax treaties in particular. This circular was revised later that year[6] to remove some of its more controversial characteristics, but uncertainties remain, in particular:

- the manner in which an "arm's-length" charge is established between the outsourcing foreign company and its Indian presence is not clarified, which can be expected to lead to substantial transfer pricing disputes;
- perhaps more significantly, the mere presence of an Indian outsourcing presence appears to be enough to implicate the permanent establishment rules under India's double tax treaty network, even though those treaties and the OECD model and commentary clearly contemplate that a functional analysis must also be undertaken to determine whether the business of the enterprise is carried on in whole or in part through that presence; and
- there is some question whether the principles laid out in the revised circular contradict the terms of certain multi-year tax holidays that have been granted in the past to nonresident companies within the Software Technology Parks of India on account of India-based outsourcing.

Telecoms and Broadcasting

More recently, 2006 saw two substantial developments in India's policies regarding the taxation of nonresident broadcasters. First, in *Satellite Television Asia Region Ltd. V. DCIT,*[7] the Income Tax Appellate Tribunal considered the taxation of payments made to a nonresident company broadcasting television programs from outside India. In this case, a Hong Kong company acquired advertising airtime from non-Indian broadcasters and sold the India portion of that airtime to Indian advertisers, using its locally incorporated India sales agency, STAR India. The tribunal held that the broadcasters themselves were engaged in a business activity in India through the activities of STAR India.[8]

Hard on the heels of that decision, the Finance Ministry launched an examination of the taxability of Indian revenues generated by nonresident satellite program providers from their broadcasts to Indian viewers. Although respect of the permanent establishment norm is apparently contemplated, there is some concern among broadcasters that the separate requirement that all broadcasters (regardless of residence) register in India as a condition of being permitted to downlink to Indian satellite receiving stations will cause an Indian permanent establishment to be found in virtually all cases.[9]

By contrast, a 2005 decision gave comfort to suppliers of telecoms hardware by confirming that a nonresident supplier does not have an Indian permanent establishment, and has no business profits taxable in India, by reason of sales of telecoms hardware for use in an Indian telecommunications facility, as long as the sale is solicited, negotiated and concluded wholly outside India.[10]

Conclusion

The recent developments summarized above lead to the conclusion that the Indian tax authorities' perspective on taxing foreign companies remains in flux. It is believed that they have led to a high degree of caution among U.S. and other multinationals, fearing that the landscape is subject to sudden shifts and that the authorities, whether because of populist pressures or for financial reasons, are occasionally unable to resist the siren song of higher tax revenues, even at the cost of becoming something of a renegade nation from the international tax perspective. By contrast, the institution of a steady policy that adheres to international norms, coupled with clear public signals that the authorities recognize the value of stability and predictability in this area, might do much to close the foreign investment gap between India and its neighboring competitor.

Endnotes

• The views expressed are the author's own.

[1] Panandiker, *Will India catch up with China in FDI?* HINDUSTAN TIMES, Dec. 15, 2006.

[2] Richard Andersen, Technology and Telecommunications, *The Happy Outsourcer: A Checklist of Significant Tax Considerations in Offshoring R&D, IT and Other Business Processes to China and the World,* J. TAX'N GLOBAL TRANS., Spring 2006, at 33.

[3] Based on a variety of official and unofficial Internet sources.

[4] *Sutron Corp.,* 268 ITR 156 (2004).

[5] The company's own report on the decision can be found in its 2006 annual report at *http://sec.edgar-online.com/2006/05/03/0001072613-06-001017/Section4.asp.*

[6] Circular 5/2004, available at *www.nasscom.org.*

[7] *Satellite Television Asia Region Ltd. V. DCIT,* 99 TTJ 1025 (2006).

[8] It is worth noting that there is no income tax treaty between India and Hong Kong, so the treaty-based permanent establishment concept did not need to be addressed in this case.

[9] This concern may be founded in part on the memory of a short-lived policy instituted by the Indian tax authorities during the mid- to late 1990s, asserting that companies whose Internet sites were viewable from within India had permanent establishments there. The position resulted in substantial assessments—most of them, it is understood, subsequently withdrawn—against large U.S. and other companies generating substantial Internet revenues within India, such as Sabre and Visa. The authority went so far as to place liens on the India-based receivables of those companies, which prompted the unusual response of placing this tax issue on the agenda for a high-level trade discussion at the time of then-President Clinton's visit to India.

[10] *Morotola, Inc. et al. v. DCIT,* 2005-TIOL-103-ITAT-DEL-SB, *reported at www.taxindiaonline.com;* Mitchell, *India to Tax US Outsourcing Firms,* Oct. 5, 2004.

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and assist in developing the testifying expert's testimony.

Rule No. 4: Respect the Expert's Independence

The trial lawyer is the party's advocate; the expert witness never should engage in advocacy. Although a party's trial lawyer retains the expert witness, the lawyer should encourage the expert witness to give an honest, independent opinion. A party is never served by retaining an expert witness who uncritically parrots the party's position. The court's harshest criticism in recent cases has been directed toward expert witnesses who have become rank advocates.

Rule No. 5: Prepare the Expert for Testimony

An expert's ability to defend her position on the stand under cross-examination is critical. The rules of cross-examination, however, place every advantage in the hands of the skilled cross-examiner. Indeed, an effective cross-examination is designed not to merely wound an expert, but to destroy the expert's credibility by attacking the expert's factual basis and assumptions, logic, prior statements and motives and biases. Preparation of an expert witness thus becomes crucial to the survival of the expert's credibility.

Preparation of the expert witness essentially involves exposing the expert witness to the expected lines of cross-examination in advance. In order for the trial attorney to prepare the expert properly, the attorney must anticipate the questions to be asked by the other side. The other side's counsel will be working closely with her own experts to prepare the cross-examination. Thus, in order for the trial lawyer to anticipate the questions to be asked, the trial lawyer must absolutely understand the area of expertise, the relevant facts in the case, and the soft underbelly of his own expert's report. The trial lawyer then must put himself in the shoes of the other side and plot out an effective and destructive cross-examination. The expert should then be subject to the best possible destructive cross-examination—*before* she ever takes the stand. The goal is to prepare for every possible avenue of attack and to eliminate any surprises at trial.

Rule No. 6: Prove up the Expert's Factual Assumptions

Remember the Prime Directive: facts, not experts, win transfer pricing cases. An expert's opinion evidence will be effective only if it is based on facts in the record

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