Circular No. 5 /2004

F.No.500/67/2003-FTD
Ministry of Finance
Department of Revenue
Central Board of Direct Taxes
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New Delhi dated the 28th September , 2004

To

All Chief Commissioners/Directors General of Income-tax.

Subject: Taxation of IT enabled Business Process Outsourcing Units in India.

A non-resident entity may outsource certain services to a resident Indian entity. If there is no business connection between the two, the resident entity may not be a Permanent Establishment of the non-resident entity, and the resident entity would have to be assessed to income-tax as a separate entity. In such a case, the non-resident entity will not be liable under the Income Tax Act, 1961.

2. .However, it is possible that the non-resident entity may have a business connection with the resident Indian entity. In such a case, the resident Indian entity could be treated as the Permanent Establishment of the non-resident entity. The tax treatment of the Permanent Establishment in such a case is under consideration in this circular.

3. During the last decade or so, India has seen a steady growth of outsourcing of business processes by non-residents or foreign companies to IT enabled entities in India. Such entities are either branches or associated enterprises of the foreign enterprise or an independent Indian enterprise. Their activities range from mere procurement of orders for sale of goods or provision of services and answering sales related queries to the provision of services itself like software maintenance service, debt collection service, software development service, credit card/ mobile telephone related service etc. The non-resident entity or the foreign company will be liable to tax in India only if the IT enabled BPO unit in India constitutes its Permanent Establishment. The extent to which the profits of the non-resident enterprise is to be

attributed to the activities of such Permanent Establishment in India has been under consideration of the Board.

4. A non-resident or a foreign company is treated as having a Permanent Establishment in India under Article 5 of the Double Taxation Avoidance Agreements entered into by India with different countries, if the said non-resident or foreign company carries on business in India through a branch, sales office etc. or through an agent (other than an independent agent) who habitually exercises an authority to conclude contracts or regularly delivers goods or merchandise or habitually secures orders on behalf of the non-resident principal. In such a case, the profits of the non-resident or foreign company **attributable to the business activities carried out in India by the Permanent Establishment** becomes taxable in India under Article 7 of the Double Taxation Avoidance Agreement.

5. Paragraph 1 of Article 7 of Double Taxation Avoidance Agreement provides that if a foreign enterprise carries on business in another country through a Permanent Establishment situated therein, the profits of the enterprise may be taxed in the other country **but only so much of them as is attributable to the Permanent Establishment**. Paragraph 2 of the same Article provides that subject to the provisions of Paragraph 3, there shall in each contracting state be attributed to that Permanent Establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a Permanent Establishment. Paragraph 3 of the Article provides that in determining the profits of a Permanent Establishment **there shall be allowed as deductions expenses which are incurred for the purposes of the Permanent Establishment including executive and general administrative expenses so incurred,** whether in the State in which the Permanent Establishment is situated or elsewhere. What are the expenses that are deductible would have to be determined in accordance with the accepted principles of accountancy and the provisions of the Income Tax Act, 1961.

6. Paragraph 2 contains the central directive on which the allocation of profits to a Permanent Establishment is intended to be based. The paragraph

incorporates the view that the profits to be attributed to a Permanent Establishment are those which that Permanent Establishment would have made if instead of dealing with its Head office, it had been dealing with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market. This corresponds to the "arm's length principle". Paragraph 3 only provides a rule applicable for the determination of the profits of the Permanent Establishment, while paragraph 2 requires that the profits so determined correspond to the profit that a separate and independent enterprise would have made. Hence, in determining the profits attributable to an IT enabled BPO unit constituting a Permanent Establishment, it will be necessary to determine the price of the services rendered by the Permanent Establishment to the Head office or by Head office to the Permanent Establishment on the basis of "arm's length principle".

7. **The "arm's length price" would have the same meaning as in the definition in Section 92F(ii) of the Income Tax Act.** The arm's length price would have to be determined in accordance with the provisions of Section 92 to 92F of the Act.

8. The CBDT Circular No.1/2004 dated 2nd January, 2004 is hereby withdrawn with immediate effect.

9. The contents of this Circular may be brought to the notice of all officers in your region.

Yours faithfully,

[Sandeep Goyal]
Under Secretary(FT&TR)-I
Central Board of Direct Taxes