Outsourcing, like everything else in life, has a tax effect. The well-informed and well-advised service provider and customer takes into account the tax benefits and tax detriments of outsourcing in structuring the transaction, pricing the services, and negotiating the terms of an outsourcing services agreement. Because the tax costs of an outsourcing transaction can be significant, they must be addressed early on in a transaction.

The customer, in analyzing any potential cost savings that might be generated by outsourcing, needs to factor in certain taxes that would not apply if the corporation were to retain the outsourced function. The customer must understand the tax implications of the proposed transaction before generating a request for information (RFI) or request for proposal (RFP) from prospective service providers, and certainly before sitting down to negotiate a deal. For the service provider, when formulating its proposed delivery solution and analyzing its business case, it must take into account the tax costs that will be generated as a result of the proposed transactions.

A tax “surprise” can sidetrack the negotiations of an outsourcing transaction, and in some cases completely derail the project. That’s why it is important that both sides understand the tax issues as early in the life of the deal as possible. We will lay out some of the less obvious tax considerations that both service providers and outsourcing customers should bear in mind when considering a cross-border outsourcing transaction. The number of tax considerations to bear in mind is myriad, and limited only by the number of countries involved and the creativity of their taxing systems. This article discusses only some of the potential issues and only in very general form. Local country tax advice is essential any time you undertake a cross-border outsourcing.

The Basics: Sales And Property Taxes

When a service provider and a customer sit down to negotiate the price of an outsourcing transaction, one of the first tax issues they will confront is that of who will bear the sales tax on the contemplated provision of services. These taxes may include sales, use, excise, value-added (VAT), services, consumption, goods and services, and other similar taxes that may be levied by various jurisdictions on the provision of services. Many services agreements state quite plainly that prices in the agreement include (or do not include) sales taxes. Beyond that bald statement, however, there is much more to say about sales taxes.

For instance, assume that the service provider has a subsidiary with offices in the U.S. and a subsidiary that has offices in another country (“Country A”) and assume that the provider will offer services to its U.S. customer through its American office. However, in order to perform the outsourced function properly, the service provider needs to use the services of its office in Country A. Under these circumstances, Country A may impose a value-added-type tax on the Country A office’s provision of services to its U.S. office. Under these circumstances, Country A may impose a value-added-type tax on the Country A office’s provision of services to its U.S. office. Should the service provider or the customer be financially responsible for this added tax?

In considering its price structure, the service provider should be aware of any taxes that will be imposed on its internal services to itself and whether or not those taxes are recoverable. Many taxing jurisdictions provide for the recovery of value-added-type taxes where the end users of the services are persons who are not residents of that jurisdiction. If there is an applicable exemption or recovery, there will generally also be paperwork involved that both parties must complete, and the agreement between the parties should contemplate the provision of information nec-
necessary to complete such paperwork. The customer also should be aware that the service provider may be subject to internal sales taxes and might try to pass along those costs to them. In addition, the completion of the paperwork may impose an additional cost burden on the parties that the agreement between the parties might address.

Sales taxes are often considered “trust fund” taxes—they are taxes due by purchasers of goods and services that the provider must collect and pay over in trust to the applicable taxing jurisdiction. Many U.S. jurisdictions therefore impose personal liability in certain circumstances on persons who were responsible for collecting and paying sales taxes if, in fact, the company fails to collect and pay over those taxes. This means that such a person could end up paying out of his or her own pocket if sales taxes are not properly paid.

In addition, there are often available exemptions from sales taxes of which the parties should take advantage. For instance, state statutes often tax a limited range of services and provide an exemption for sales for resale. Therefore, no matter who ends up bearing the burden of sales taxes, the service provider and the customer should consider specifying in the agreement that the person required by law to collect and pay over sales taxes will do so and that the parties will cooperate to recover any sales taxes in the event that there is an available exemption.

Another issue that buyers and sellers of global services need to consider is which party should bear the risk of a change in law. Presumably, each side has based its pricing or spending decisions assuming a certain level of sales taxes. If the assumptions change (for instance, because rates go up or certain transactions that were not taxable no longer qualify for an exemption), the agreement could specify who must bear the burden of the increased costs.

The arrangement between a service provider and an outsourcing customer might also give rise to property taxes levied against the tangible and/or intangible property being used to provide the services. Well-advised service providers and outsourcing customers will determine what sort of property tax burden will arise as a result of the transactions they propose and will negotiate as to which side will bear that burden. The parties should look especially closely at property taxes levied on intangibles (for example, Maryland imposes a property tax on certain kinds of computer software), as there may be an unexpected burden levied by a particular jurisdiction on the use of that intangible.

Each of the considerations described above should be examined in each taxing jurisdiction in which services are to be performed or received so that there are no tax issues that arise with respect to sales or property taxes that could have been avoided, mitigated, or taken into account with proper planning.

### Withholding Tax Issues

In a multinational arrangement, multiple issues arise with respect to the interaction of different taxing systems. Let’s look at the imposition of withholding taxes and the consequences of withholding taxes on outsourcing arrangements. There’s often a risk that the activities contemplated by an outsourcing arrangement will lead to either the service provider or the outsourcing customer being deemed to be engaged in a trade or business in a foreign country, thus subject to the income taxation regime of that country.

Many countries have their own withholding tax laws that impose some rate of taxation on income sourced within that country being paid to persons outside that country. For the avoidance of double taxation, many countries have entered into income tax treaties that govern which country has the right to tax certain types of income in certain circumstances. However, there is no universally accepted notion of “source” among taxing systems. Generally, the U.S. and many other developed countries tie the source of income to the economic activity or assets that give rise to that income. In addition, many countries also have some sort of credit or elimination system so that income that has been previously taxed by one taxing jurisdiction is not again taxed at the full rate by the “home” taxing jurisdiction.

Outsourcing customers and service providers should obtain advice in each of the countries affected by the services in order to determine the applicability of those countries’ rules to them. The U.S. taxes the income of certain types of persons, such as American citizens and corporations organized under the laws of any state on a worldwide basis. The U.S. generally taxes foreign persons on a territorial basis (that is, on the basis of income from domestic sources, as described below). The federal government imposes a 30% tax on “fixed or determinable annual or periodical” gains, profits, and income from sources within the U.S. other than most capital gains paid to foreign persons. The definition of “fixed or determinable annual or periodical” income could in certain circumstances encompass periodic payments made under a service agreement between a service provider and an outsourcing customer.

Suppose that a service provider is a multinational corporation with offices in several countries outside the U.S. and will provide international employee-relocation services to an outsourcing customer. It will provide the customer’s U.S. employees with some amount of assistance, relating to their move, through independent contractors hired and supervised by the service provider from its
offices in Country A. Assume these supervisory activities do not arise to the level of a trade or business in the U.S. (for which there are special rules that will apply instead, as described below). In the foreign country to which an employee is moving (call it Country X), the service provider will provide house hunting and other assistance as well as relocation and other ongoing counseling to the employee through its offices in Country X. For these services, the service provider will receive a fee of 100X per year under its contract with an outsourcing customer. Assume that 10% percent of the service provider's fee can be allocated to services supplied by its agents in the U.S. and 90% of the time in rendering services is spent in Country A. Under the rules discussed above, unless there is an applicable income taxation treaty, 10X of the fee would be deemed to be U.S. source income, taxable at 30%. There may be further complexities as between Countries A and X, depending on the respective tax laws. As always, local advice is crucial to make sure that no further issues are created by the relationship described above.

The question then is how the U.S. (or any other country with similar laws) enforces these rules. The answer is through a withholding tax. The U.S. requires the payor of income to a payee who is subject to the taxes described above to withhold 30% of payments of “fixed or determinable annual or periodical” income, unless a treaty applies to reduce or eliminate the withholding. If an outsourcing customer pays a service provider from its U.S. office, the customer would technically have to withhold at least 3X of the contract price, and possibly as much as 30X if it cannot properly allocate the services between the U.S. and Country A. If the U.S. and Country A do not have an income-tax treaty, the service provider will have suffered a (potentially) non-recoverable tax cost of 30%.

Each jurisdiction has its own withholding tax rules that will require withholding tax from payments of cash to non-residents of that jurisdiction. Applicable treaties can reduce or eliminate withholding taxes. When planning and pricing an outsourcing transaction, it behooves all of the parties to examine the applicable withholding rules and whether, if a service provider is a multinational company, a better result can be obtained by having services originate from one or another of the provider's offices. In addition, if there are withholding taxes, the party suffering the withholding will want to ask for proper documentation of that withholding so it can obtain any applicable and available credit against its local jurisdiction taxes for the taxes paid over to the foreign country. If there is no way in which to avoid withholding taxes on a transaction, and a credit is either unavailable or unusable (for example, a U.S. corporation may not be able to use foreign tax credits when in a net operating loss position), the service provider may ask for a “gross-up” to protect its net return from erosion by withholding taxes. This gross-up can either be an amount equal to the amount of the withholding tax or, in a more sophisticated version, can take into account withholding taxes imposed on the gross-up amounts themselves.

The Permanent Establishment Risk

If the contemplated transactions would take place in part in any country other than a country in which the service provider and the outsourcing customer are both resident, there is some risk that the transactions will cause the party that is not resident in that jurisdiction to develop a “permanent establishment” or “residence” or otherwise be taxable on all of its income from that jurisdiction.

For instance, assume a service provider performs call-center services in Country B, its country of residence, and sends personnel to Country A to provide its customer with on-site support in Country A to train its customer's employees. The call-center customer is a resident of Country A, but sends personnel to Country B to oversee the activities of the call center and to train the call-center personnel. The question is if those activities will cause either the service provider to have a “permanent establishment” in Country A or the call-center customer to have a “permanent establishment” in Country B. Each country has its own rules on permanent establishment and residence type rules, and income-tax treaties further inform and modify those rules. Both sides should take local country advice as to the tax consequences to it if it does not otherwise pay tax in that jurisdiction.

Absent the application of an income tax treaty, in the U.S., there is a twofold risk. The first is that the activities would give rise to income “effectively connected with the conduct of a trade or business in the U.S.;” the second risk is that the foreign company would also be subject to a 30% “branch profits tax” on its source income. If a foreign corporation is deemed to be engaged in a trade or business in the U.S., that corporation is taxable on normal graduated rates. The branch tax is supposed to replicate the second level of tax imposed on corporate distributions. For instance, whereas dividends and interest from a U.S. corporation might be subject to a withholding tax as described above, a foreign corporation deemed to have a U.S. branch would suffer a 30% tax on the dividend equivalent amount (whether or not actually repatriated). Various treaties reduce the impact of the branch tax.

Whether or not a corporation is engaged in a trade or business in the U.S. is a facts and circumstances inquiry. Unfortunately, the code does not provide a comprehensive definition of a “trade or business.” It does, however, provide that “trade or business within the U.S.” includes personal services, but excludes trading in stocks or securities through a U.S. resident broker, commission agent, custodian, or other independent agent, so long as at no time during the taxable year does the taxpayer maintain an office.
in the U.S. through which such trades are effected. A corporation must conduct active, continuous, and regular business activities in the U.S. that go beyond the mere passive ownership of property in order to be engaged in a U.S. trade or business. Ministerial clerical or collection-related activities do not generally constitute a U.S. trade or business. However, in cases where a foreign person (or its agent) has managed property in the U.S. in an active manner, the courts have found that the person is engaged in a U.S. trade or business.

If the parties are able to avail themselves of an income-tax treaty, a different set of rules may apply. If a party is eligible for the provisions of an applicable income-tax treaty, that party may choose to apply either the income-tax treaty or domestic law in the U.S. Both the U.S. and OECD Model Income Tax Treaties include provisions that govern the taxation of “business profits” earned by an enterprise of a contracting state. The general rule under treaties is that only the country of residence may tax business profits; however, where an enterprise maintains a “permanent establishment” (such as a fixed place of business through which the business of an enterprise is wholly or partially carried on) in the other jurisdiction, that jurisdiction may tax those business profits, obliging the enterprise to seek a credit in its country of residence.

Though the concepts of a “permanent establishment” and a “U.S. trade or business” are similar, there are important differences. For instance, under U.S. law, the “business” that must be carried out in order to create a permanent establishment has a similar definition to a “U.S. trade or business”; however, the concept of a “permanent establishment” generally requires a more stable or permanent business connection within the U.S. before the enterprise is subject to U.S. income taxation. Thus, if a foreign corporation entitled to treaty benefits does not maintain a “permanent establishment” and it elects to apply the treaty, it will only be taxable on U.S. source investment-type income (which may be reduced or eliminated by other treaty provisions). If a foreign corporation entitled to treaty benefits does maintain a “permanent establishment” within the U.S., it will be taxed on the income attributable to that permanent establishment.

The foregoing describes only how the U.S. deals with the issue. Popular countries for outsourcing, such as India, may have similar regimes that require a facts and circumstances analysis of the relationship. Both parties should carefully consider whether the activities contemplated by the services agreement would subject either side to income tax in any jurisdiction in which it does not otherwise already pay tax.

Conclusion

In an outsourcing transaction, both the service provider and the customer must be sensitive to the various and complicated tax issues that might be applicable, given the bottom-line impact these issues may have on the companies. Competent tax advice (both U.S. and foreign) should be sought to help both parties navigate the tax minefield safely.

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