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Outsourcing and Tax

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by Alistair Maughan, Sonia Girgis

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This article covers two subjects. Firstly, it addresses the complex tax issues that can arise on an outsourcing project. And, secondly but no less importantly, it explains the connection between tax, outsourcing and Attila the Hun. Given the amounts at stake, readers involved in outsourcing projects should have a clear grasp of the first subject – as well as a curiosity to discover why specialists in tax and/or outsourcing are such wild and crazy guys.

Tax issues are clearly a significant driver of business behaviour. Companies go to considerable lengths to structure their arrangements in the most tax advantageous way within what the law allows. Tax issues become proportionately more difficult as transactions cross borders and potentially involve more than one possible tax regime.

But whereas companies routinely use tax planning as part of M&A or corporate reorganisation programmes, perhaps surprisingly tax issues are often an afterthought in many outsourcing transactions. This may be because outsourcing originated as a simple concept of an in-country arms' length services transaction with few tax complexities or opportunities for legitimate tax planning. But that has now changed and tax issues loom large in many outsourcing deals – especially those with a heavy financial services component or cross-border element.

This article introduces the most common tax issues that should be considered on any outsourcing or offshoring project. Clearly, the various issues and the application of tax laws vary according to each individual transaction and depend highly upon the parties' exact circumstances and the services, structures and jurisdictions involved. This article is written primarily from a UK and wider European base – although similar principles ought to concern parties to outsourcing transactions in the United States or any other country.

VAT and Sales Tax Issues

The starting point for any tax treatment of an outsourcing arrangement – at least in Europe – will be that value added tax ("VAT") or sales tax will apply, but that in all other respects the service provider will bear all taxes assessed on its in-feed costs or service charges. In most cases, the services being supplied will be such that the service provider will be required to charge VAT to the customer on its fees for the outsourced services, thus adding an additional percentage (17.5% in the UK, but varying across the EU) to the service charges. In most cases, this will not result in additional cost to the customer. The reason for this is that VAT incurred by a company in the course or furtherance of its business (known as "input tax") can be recovered from the relevant country taxing authority. The ability to recover the input tax in full is only available where the company makes "fully taxable" or zero rated supplies. A problem arises, however, where the company's supplies falls within the definition of "exempt supplies", that is they are not required to charge VAT to its own clients. Such companies fall into a no-man's land in that whilst they are required to pay VAT on the purchase of goods or services, they cannot recover the input tax.

The problem of irrecoverable VAT is most significant in the financial services sector and, in a number of cases, can result in a planned outsourcing becoming unaffordable. As a result, a number of techniques and tax planning ideas have been developed in the last 10 years to resolve this issue. For example, if the contract can be structured so that the services supplied by the service provider are themselves exempt, then no VAT will be payable. As one would expect, tax authorities such as HM Revenue & Customs in the UK tend not to agree with the technical basis of these structures and the courts (including the European Court of Justice) have been required to settle a number of disputes.

Whilst there is still a great deal of uncertainty in this area, what is now clear is that the UK's VAT legislation is in conflict with EU law in a number of important areas and the savvy taxpayer will use EU legislation to structure the contract as this will in most cases give a much better after-tax result.

Having said that the normal assumption will be that VAT applies over and above the service charges, it should be said that this is not an invariable practice and it is possible to contract on a "VAT inclusive" basis – although it may be hard to get a service provider to bear this risk. But it's an issue that could be negotiated if addressed from an early stage. If discussions proceed down this route, one would also expect to discuss a mechanism for apportioning the change of law risk – either in relation to the imposition of new tax charges or in relation to any future change in VAT rates.

Equally, it is possible to address separately in the contract – or even via separate contracts – elements of the services required that are, respectively, presumptively VAT-bearing and VAT-exempt. If that sort of structuring is legally possible, the principles should be identified at an early stage and worked through with tax specialists.

As VAT is a European tax, where the outsourcing transaction involves non-EU countries there may be scope to split the supplies so as to avoid VAT on supplies made to non-UK companies. A careful review of the dreaded "place of supply rules" cannot be avoided if one is seeking to structure a transaction in this way.

Transfer or sale related taxes

Early on in the outsourcing planning process, it is important to carry out an analysis of the assets to be transferred to service provider. This would normally form a core part of outsourcing due diligence from the perspective of allowing an accurate assessment of the likely cost base. But there are additional tax consequences in an offshore outsourcing situation because a transfer of business assets offshore is considered a disposal by the company for tax purposes, which can, depending on the nature of the asset, give rise to a liability for capital gains tax, a charge under the relevant intangible assets rules or a capital allowances balancing charge. An analysis will determine if some or all of these tax charges can be avoided.

Taxable presence

The outsourcing of services offshore can result in a company being liable to pay tax in the jurisdiction where the service provider is resident. Clearly, this can have very undesirable results. Whether or not there is a taxable presence offshore will depend on a number of factors and will turn to the facts in each case.

A careful review of the relevant double taxation treaty is necessary to confirm whether there is a problem and, if so, whether this can be avoided, for example by using the independent agent exemption found in most treaties, or whether it can be argued that there are no profits attributable to the permanent establishment. Some tax authorities are known to take a stricter view on this issue than others. Care should therefore be taken to structure the transaction to minimise this risk.

Transfer pricing

Depending on the degree of association between the parties involved in the outsourcing agreement, there may be a transfer pricing issue. Transfer pricing rules require associated companies to charge an arm's length price for the supply of goods and services. If the tax authority considers that the price charged by the service provider is excessive, it may apply the relevant transfer pricing rules to reduce the tax deductions allowed to outsourcing customer to the level of deductions which would have applied had it paid the lower arms-length price. Similarly, in an offshoring, if the tax authority of the offshore service provider considers that the price charged by the service provider is too low, it may apply the offshore transfer pricing rules to subject the service provider to tax on the level of profits that it would have earned had it charged a higher arms-length price.

This is typically an issue in multi-country outsourcing transactions where the outsourcing customer may wish to pay a single global price to the service provider for all services to be provided around the group, regardless of location. The company must ensure that there is a re-charge made to its subsidiaries and this is on an arm's length basis to comply with transfer pricing legislation. In such projects, tax advisers will need to work carefully alongside the project teams as they develop the project charging structures in order to make sure that charging, billing and invoicing procedures that work perfectly well for the parties' Governance aims do not leave them in a considerably worse tax position.

Withholding tax

Withholding tax is payable by the service provider to the extent that the structure involves the payment of any interest, dividends or royalties to the outsourcing customer. It will therefore be necessary to consider whether the service provider will be required to pay withholding tax to the tax authority of the relevant jurisdiction. If there is a withholding tax problem, some tax planning may be required to reduce or mitigate the amount that the service provider is required to withhold as withholding tax can be a real cost in a number of cases. Parties often seek to rely on an appropriate double tax treaty to resolve this issue.

Incentives in foreign jurisdictions

Many offshore outsourcing destinations offer tax incentives to encourage companies to outsource to service providers within their jurisdiction. These would usually be in the form of income tax relief. There may also be additional tax incentives offered at the regional level in addition to the government incentives. The affect of applicable tax breaks should be evaluated early on in the process, before key decisions are taken about the location of any offshoring services.

Most of these tax incentives come with strings attached and it will be important to seek early tax advice to make sure that these conditions are built into the outsourcing contract and that the resulting tax benefits are shared, and not fully absorbed by the service provider alone.

Indemnities in respect of affiliate losses

A common problem in most large outsourcing projects is how to ensure that an outsourcing customer secures protection in respect of losses suffered by its (non-contracting) affiliates who take the benefit of the outsourced services. Typically, one would ensure that the supplier indemnifies the customer explicitly for such losses. However, this approach is not without problems. An award of damages to the customer for losses incurred by one of its subsidiaries may itself be taxable.

Certainly in some countries, including the UK, the principle exists that the right to sue is an asset for capital gains tax purposes and the receipt of damages results in the disposal of that asset and is subject to tax. In the UK at least, there are some exceptions to this rule (for example, where a payment is made under an indemnity or warranty in a sale and purchase agreement) but damages received by an outsourcing customer do not fall within any of these exceptions.

This problem can be dealt with contractually by ensuring that there is a gross-up clause in the contract, which increases the damages (or indemnities) by the anticipated tax payable.

Conclusion

The cost savings that outsourcing projects – especially offshore or multi-country projects - are designed to deliver can be eroded if the arrangements are not carefully structured from a tax perspective. As there are a number of tax issues which can be quite complex, it is important to identify early in the planning stages of structuring the transaction those issues that are relevant to the particular outsourcing project and to factor those issues into the deal structure exactly as one would do for any other corporate organisation project.

And Finally ... Tax, Outsourcing and Attila the Hun

Well if you've read this far, you're hopefully still curious to find out what does, in fact, link tax, outsourcing and Attila the Hun. The answer is to be found in one of the few reported Court cases about an outsourcing relationship.

The case of *Customs and Excise Commissioners v FDR Limited* was heard in the UK Court of Appeal in 2000. You'd be forgiven for not having heard of it, let alone read it. But in that case, one of the judges came up with the finest ever description of outsourcing.

In a rare moment of poetry amid a long and detailed analysis of the VAT treatment of a credit card outsourcing transaction, the learned judge explained that:

"[FDR] … is engaged when some or all of the banks' services … are "outsourced" to FDR, **to use the barbarous expression apparently current in the trade.**" [*emphasis added*]

According to the dictionary, “barbarous” means *“uncultured, uncivilized, unpolished; rude, rough, wild, savage. (Said of men, their manners, customs, products.) The usual opposite of civilized.”*

And who came up with this perfect description of outsourcing? None other than the aptly-named Lord Justice Laws. With a name like that, surely he must be right?

So next time you find yourself pondering the meaning of your outsourcing life, remember that you’re not the cultured business-person that everyone else assumes. In fact, you are a barbarian, rampaging at the gates, wielding a rude and savage business model, not fit for this modern, civilized world. We love that image. It’s what keeps us going late at night on all those outsourcing project negotiations!

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For more information about Morrison & Foerster's European tax practice, please contact: Trevor James, TJames@mofo.com or Sonia Girgis SGirgis@mofo.com.