

A Practical Guide To The Relevant Budget Proposals For IT Companies – July 8,2009

A PRACTICAL GUIDE TO THE RELEVANT BUDGET PROPOSALS FOR IT COMPANIES S

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1. Extension of the tax holiday under Sections 10A and 10B by one more financial year. As things stand now, the tax holiday will expire with FY 2010-11. Implications for IT Companies operating as STP units: If these companies are posting profits, this extension would only marginally help as much of the benefit arising out of this extension will be eaten away by the increase in MAT, discussed in Point No. 2. It must be remembered that STP Units are entitled to income tax exemption only on their export profits and not on their domestic profits. 2. Increase in MAT to 15% from FY 2009-10 : The minimum alternate tax payable by companies, on the basis of the audited profits shown in the financial accounts, subject to certain adjustments, has been increased from 10% to 15%. As per the MAT provisions, the income tax paid under MAT provisions are eligible to be adjusted against the normal tax paid, for a period of 7 years, which has now been increased to 10 years. Implications for IT Companies operating as STP Units STP Units, operating as 100% EOUs are entitled to a tax exemption in respect of profits from their export sales. The effective MAT rate for FY 2009-10 inclusive of surcharge (which is applicable for companies with income of over Rs 1 crore) and Cess would now be 16.995%, up from the present effective rate of 11.33%. MAT is applicable on the audited profits as reported in the financial accounts. In contrast, income tax (which is currently at an effective rate of 33.99%) is applicable on the income computed as per the provisions of the Income tax Act. The profits computed as per the Income tax Act are normally significantly lower as compared to the profits as per the audited accounts

and consequently, the effective tax that would be paid by STP Units would almost be similar as between the higher MAT and the normal tax rate of 33.99% on profits computed as per the IT Act. The result is that, STP Companies would need to shell out more tax in FY 2009-10. However, the MAT paid can be adjusted against the normal tax liability, over a period of 10 years. However, this will have very little impact, as any company would need to continue to pay the MAT, in any case. The following is an example of how the MAT would work out for many IT Companies operating as STP Units:

Under MAT

Under normal

provisions

Export Sales 85 85

Domestic Sales 15 15

Total Sales 100 100

Book Profits 20 20

Adjustments under IT Act 3

Profits under IT Act 17

Tax Rates 17.00% 33.99%

Tax Element 3.40 0.87

To be carried forwarded for future adjustment 2.53

3. Amendment related to central excise duty on packaged software licenses: The central excise law has been amended to provide for an exemption in respect of the value of the license given by packaged software manufacturers, while computing the excisable value of the packaged software 'manufactured' by them, for purposes of levy of central excise. The new provisions stipulate that the packaged software manufacturers should register themselves with the Service tax Department and pay service tax on the value of such licenses. The Government was expected to clarify the double taxation in respect of software licenses, involving the levy of VAT and Service tax. Instead, the Government ended up barking up the wrong tree by clarifying on the applicability of excise duty on software licenses. Consequently, the double taxation involving the levy of service tax and VAT on the value of software licenses sold in the domestic market continues. It is amazing that the Government has not understood the simple fact that the only mode by which packaged software is sold, is thro' the licensing mode.

Implications for IT Companies involving in development of packaged software: Software, whether packaged or customized, is treated as 'goods' for purposes of levy of sales tax/VAT. Licensing of software is one of the most popular and most widely used methods, by packaged software developers. Since, in most cases, the transfer of the right to use the software, viz. The software license is transferred by the electronic mode, no excise duty is attracted. With the new Notification No. 22/2009-CE dated July 6, 2009, the Government has made it clear that central excise duty is not attracted on the value of software license, vis-a-vis packaged software developers. The Notification also stipulates that packaged software developers, selling software licenses, should get themselves registered with the Service Tax Department and pay service tax. The legality of this Notification is questionable, as service tax cannot be levied on sale of software licenses which are actually covered by the levy of VAT/sales tax. However, the double taxation involving the levy of service tax and VAT on the value of software licenses sold in the domestic market continues. However, some bit of a problem is to be anticipated from the Central Excise Department, as the amendment confirms the view that packaged software manufacturers have to register themselves with Central Excise Department. 4. Changes in FBT provisions The Fringe Benefits Tax is proposed to be abolished from FY 2009-10 and the fringe benefits are proposed to be treated as perquisites for levy of tax, in the hands of the employees. Hence, the tax incidence is getting shifted from the employer to the employees. ESOPs and Contributions to superannuation funds of over Rs 1 lakh, have already been notified as perquisites.

The CBDT has been authorized to specify the list of fringe benefits which are to be treated as perquisites, in the hands of the employees. Implications for IT Companies : With ESOPs getting treated as perquisites, Mr Ramesh Srinivasan will now have bear the income tax at the applicable rates (which is now at 30.3% for individuals). However, the effective tax of ESOPs when it was being treated as a fringe benefit was a whopping 45% ($100 \times 33.99 \times 1.3399$), which has now come down to 30.3%. FBT being a disallowable expenditure, would effectively push up the costs for ESOPs under the earlier regime.

Many Companies have made use of the FBT provisions to introduce tax friendly salary packages for their employees, which would need to be re-looked at, in the light of the proposals to bring fringe benefits

under the perquisites regime. The new dispensation would result in higher tax in the hands of the employees, with fringe benefits getting taxed at salaries, attracting higher rates of tax. 5. Abolition of surcharge for individuals and increase in basic exemption limits. Surcharge on individuals (which is applicable in cases of taxable income of over Rs 10 lakhs) has been abolished from FY 2008-09. The basic exemption limits have been marginally raised. Implications for IT Companies : Many of IT Companies' highly paid employees with income of over Rs 10 lakhs would benefit on account of the effective tax rate of tax coming down to 30.9% from 33.99%. There are no changes in the corporate tax rates or in the Dividend Distribution Tax rates. 6. Major changes in the TDS rates and Rules: Changes in the TDS rates for corporates, proposed to take effect from October 1, 2009 are given below (reproduced from the Budget Memorandum) Nature of Payment (194-I) (w.e.f. 1-10-2009)- Rent Existing Rate Proposed rate*

- a. rent of plant, machinery or equipment 10 % 2 %
- b. rent of land, building or furniture to an individual and Hindu undivided family 15 % 10 %
- c. rent of land, building or furniture to a person other than an individual or Hindu undivided family 20 % 10 %

* The rate of TDS will be 20 per cent in all cases, if PAN is not quoted by the deductee w.e.f.

1.04.2010 Under the existing provisions of section 194C of the Income-tax Act, TDS at the rate of 2% is deducted on payment for a contract. However, in the case of a sub-contract, TDS is deducted at the rate of 1%. Further, in the case of payment for an advertising contract, TDS is required to be deducted at the rate of 1%. In order to reduce the scope for disputes regarding classification of contract as sub contract, it is proposed to specify the same rate of TDS for payments to both contractors as well as sub-contractors. To rationalise the TDS rates and to remove multiple classifications it is also proposed to provide same rate of TDS in the case of payment for advertising contracts. To avoid hardship to small contractors/sub-contractors most of whom are organized as individuals/HUFs, it is proposed to prescribe following rates of TDS: (a) 1% where payment for a contract are to individuals/HUF (b) 2% where payment for a contract are to any other entity.

Nature of Payment (194-C) (w.e.f. 1-10- 2009) Contractor

Existing Rate Proposed rate*

- a. Individual/HUF contractor 2 % 1 %
- b. Other than individual/HUF contractor 2 % 2 %
- c. Individual/HUF sub-contractor 1 % 1 %
- d. Other than individual/HUF sub-contractor 1 % 2 %
- e. Individual/HUF contractor/sub-contractor for advertising 1 % 1 %
- f. Other than individual/HUF contractor/ sub-contractor for advertising 1 % 2 %
- g. Sub-contractor in transport business 1 % nil*
- h. Contractor in transport business 2 % nil*

* The nil rate will be applicable if the transporter quotes his PAN. If PAN is not quoted the rate will be 1% for an individual/HUF transporter and 2% for other transporters upto 31.3.2010. ** The rate of TDS will be 20 per cent in all cases, if PAN is not quoted by the deductee w.e.f. 1.04.2010 Further some of the rates of TDS specified for resident taxpayers have been reduced and converged to 10 per cent. In order to ease the computation of TDS, it is proposed to remove surcharge and cess on tax deducted on non-salary payments made to resident taxpayers. Implications for IT Companies : IT Companies' Accounting Teams would really need to handle TDS related issues, much more efficiently and effectively. For instance, the cost of providing a wrong PAN to a contractor, who falls under the 1%TDS bracket, could result in 19% tax being levied on the tax deducting IT companies, as in all such cases involving incorrect PANs, the deductor is expected to have deducted 20% tax, at source.

1. Changes in Transfer Pricing provisions: Section 92(C) of the Income tax Act is proposed to be amended, with effect from October 1, 2009, to provide that, where more than one price is determined by the most appropriate method, the arm's length price shall be taken to be the arithmetical mean of such prices. However, if the arithmetical mean so determined, is within 5% of the transfer price, then the transfer price shall be treated as the arm's length price and no adjustment is required to be made. Under the existing provisions, where more than one price is determined by applying the most appropriate method, the arm's length price

shall be determined at the option of the assess, at a variance of +/- 5% of the arithmetic mean of the prices determined by applying the most appropriate method. The adjustment, if any, is to be reckoned

with reference to the arm's length price so arrived at. The difference between the existing and the proposed methods can be explained by the following example:

IMPACT OF PROPOSED CHANGES IN TP PROVISIONS

Existing

provisions

Proposed

provisions

In INR In INR

Sale price for export (assumed) 80 80

Average of prices of uncontrollable comparable

transactions 100 100

Arm's length price being 95% of Section 92 (C) (ii) 95 95

Adjustment in the arm's length price 15 20

1. No changes in service tax refund rules

As against expectations, no measure has been announced to simplify the refund procedures, as applicable to services exporters. The Government has made some cosmetic changes to the existing policy dealing with refunds for goods exporters which are not applicable to services exporters.

However, going by the spirit of the new rules, services exporters including IT exporters can now file refund claims once a year. IT exporters would continue to live with the current dispensation in respect of refund claims.

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Export Sales	85	85	Domestic Sales	15	15	Total Sales	100	100
Book Profits	20	20	Adjustments under IT Act	3	3	Profits under IT Act	17	17
Tax Rates	17.00%	33.99%	Tax Element	3.40	0.87	To be carried forwarded for future adjustment	2.533	

Amendment related to central excise duty on packaged software licenses: The central excise law has been amended to provide for an exemption in respect of the value of the license given by packaged software manufacturers, while computing the excisable value of the packaged software 'manufactured' by them, for purposes of levy of central excise. The new provisions stipulate that the packaged software manufacturers should register themselves with the Service tax Department and pay service tax on the value of such licenses. The Government was expected to clarify the double taxation in respect of software licenses, involving the levy of VAT and Service tax. Instead, the Government ended up barking up the wrong tree by clarifying on the applicability of excise duty on software licenses. Consequently, the double taxation involving the levy of service tax and VAT on the value of software licenses sold in the domestic market continues. It is amazing that the Government has not understood the simple fact that the only mode by which packaged software is sold, is through the licensing mode. Implications for IT Companies involving in development of packaged software: Software, whether packaged or customized, is treated as 'goods' for purposes of levy of sales tax/VAT. Licensing of software is one of the most popular and most widely used methods, by packaged software developers. Since, in most cases, the transfer of the right to use the software, viz. The software license is transferred by the electronic mode, no excise duty is attracted. With the new Notification No.22/2009-CE dated July 6, 2009, the Government has made it clear that central excise duty is not attracted on the value of software license, vis-a-vis packaged software developers. The Notification also stipulates that packaged software developers, selling software licenses, should get themselves registered with the Service Tax Department and pay service tax.

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The difference between the existing and the proposed methods can be explained by the following example: IMPACT OF PROPOSED CHANGES IN TP PROVISIONS Existing provisions Proposed provisions In INR In INR Sale price for export (assumed) 80 80 Average of prices of uncontrollable comparable transactions 100 100 Arm's length price being 95% of Section 92 (C) (ii) 95 95 Adjustment in the arm's length price 15 20 1. No changes in service tax refund rules As against expectations, no measure has been announced to simplify the refund procedures, as applicable to services exporters. The Government has made some cosmetic changes to the existing policy dealing with refunds for goods exporters which are not applicable to services exporters. However, going by the spirit of the new rules, services exporters including IT exporters can now file refund claims once a year. IT exporters would continue to live with the current dispensation in respect of refund claims.

