Budget 2012 – Huge Disappointment for IT – Mar 20, 2012

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THE Budget proposals have come as a big disappointment for Industry in general and the IT industry, in particular. Here is an attempt to look at the major disappointments for the IT Sector….

No tax holiday for STP Units; MAT applicable for SEZ Units

The FM has not reintroduced the tax holiday for the exporting software units operating as 100% Export Oriented Units, which was withdrawn from 1-4-2011. Neither has he removed the applicability of MAT for Units in the SEZ scheme, which again, was brought into effect from 1-4-2011. While there is a justification for not extending the tax holiday for STP Units under Sections 10A and 10B of the Income tax Act, 1961, given the fact that this scheme has been in vogue for over 10 years now, there is no justification in refusing to remove MAT on SEZ Units. That the Finance Ministry continues to disregard the supremacy of the Special Economic Zones Act, 2005 over the Income tax Act, is clear. Despite that, as per the SEZ Act, 2005, no tax can be levied on SEZ Units, the Government has brought the SEZ Units under the purview of MAT thro' the back door, viz. the Income tax Act. One of the major incentives available under the SEZ scheme has been the non-applicability of the MAT and Dividend Distribution Tax on SEZ Units. This has been undone by the Finance Ministry, in what could be seen as a typical case of 'promissory estoppel'.

With the introduction of MAT on SEZ units, it goes without saying that the SEZ scheme has lost its charm, a fact reinforced by the lack of interest in the SEZ projects post 1-4-2011.

Draconian changes in transfer pricing regulations

The IT sector's disappointments do not end here. As is known, the transfer pricing regulations are largely applicable to the IT Sector. In fact, a significant portion of the IT Industry is subject to the transfer pricing regulations. In what could result in a substantial increase in the scope of applicability of the transfer pricing regime to the IT sector, the Budget has proposed to amend the term 'international transaction' to include within its ambit, transactions involving intangibles, borrowings, guarantees, and other items and that too, with a retrospective effect from April 1, 2002. It has been explained that intangible property would include marketing intangibles, customer-related intangibles, human capital related intangibles, location related intangibles, etc. It is clear that a lot of subjectivity in getting introduced into the transfer pricing regime. Till now, these were outside the purview of the transfer pricing regime. But, to bring these retrospectively from April 1, 2002 would subject the IT sector to huge hardship, especially considering the fact that, the transfer pricing regime has been marked by unforeseen confusion and litigation.

In terms of the proposed amendment for determining the arm's length price, the upper ceiling as the tolerance range would now be kept at 3% (with effect from 1-4-2012) as compared to the 5% variation currently existing as brought about by the Finance Act, 2011. This amendment would, again, create a lot of issues for the Indian back end companies, which render services to their parent companies. In yet another amendment which could create a lot of issues for the Indian Subsidiaries of MNCs, it is proposed to eliminate viewing of this 5% range as a standard deduction in terms of all assessment proceedings pending before the Assessing Officer as of October 1, 2009. If the assessments have been concluded prior to October 1, 2009, such cases would not be re-opened. Till now, the Indian Companies rendering services to their parent companies have been deducting 5% as a standard deduction and the denial of this benefit could result in large scale adding back of profits for levy of tax, under the transfer pricing regulations.

In another dampener, Section 92CA of the Income-tax Act is being amended, retrospectively from July 1, 2002 in terms of which, the Transfer Pricing Officer ('TPO') would be authorized to initiate a determination of the arm's length price of an international transaction, in the course of proceedings before him even if the transaction was not referred by the Assessing Officer, in cases where such international transactions have not been reported by the taxpayer, as required by Section 92E. The only saving grace is that, it is proposed that the Department would not go in for-reopening of the examination proceedings only because of this measure. This amendment would affect Indian Subsidiaries of MNCs which could have entered into short term loan agreements, loan guarantees, etc. where no price had been charged and consequently not reported.

Yet another dampener for the Industry in general and the IT sector/SEZ Units in particular, is the proposal to extend the transfer pricing scheme to domestic firms. In terms of the Finance Bill, the Department can re-compute the income (based on fair market value) under Chapter VI-A and Section 10AA, of the SEZ undertaking to which profit linked deduction is provided if there are transactions with the related parties or other undertakings of the same entity. The Bill further clarifies that the compliance burden will be applicable to transactions that will exceed threshold of Rs 5 crore.Importantly, companies will now have to maintain proper documentation, going forward. Surely, life for medium to large sized SEZ units would become much tougher, after the Budget.

In what could be a seen as a consolation, the Government is also introducing the APA scheme, under which, a tax payer and the tax authority on an appropriate transfer pricing methodology over a fixed period of time in future. Of course, we would need to wait to see how this makes a change at the ground level.

Retrospective amendments to Section 9(1) would affect software importers

In terms of the retrospective amendments carried out by the Finance Bill 2012, taking effect from 1976, payments for import of shrink wrapped software packages, irrespective of the medium in which they are imported, would now be treated as 'royalty' taxable in the hands of the non-residents. The benefit of the decisions of the Delhi High Court in the Ericsson AB case would no longer be available. In the light of this statutory amendment, software importers are likely to be saddled with huge tax liabilities. In terms of the other retrospective amendments, it would no longer be possible to take the view that, no TDS needs to be effected in respect of payments to non-residents for services rendered and utilized outside India. Since, most of these services would be taxable in India, in the light of these amendments, IT companies importing services would be well advised to ask their

non-resident service providers to obtain PAN, as the TDS rate that is applicable to payees who have not furnished their PAN details, is a whopping 20%.

No relief from double levy of service tax and VAT

The IT sector was also expecting some relief in terms of the removal of the double levy of VAT and service tax on software licensing. With the service tax law moving into the negative list based scheme, the IT sector will have nothing to gain. That the Union Government would continue to levy service tax on software services without considering the fact that transfer of goods are also involved, becomes clear, when one goes thro' the voluminous Budget circular issued by the Board, on service tax issues. The TRU Circular seems to legitimize the levy of service tax on the entire value of software related transactions such as license fee, annual maintenance contracts, etc.

No relief on service tax refunds

There was also a lot of expectation that the Budget would ease the flow of refund of unutilzed cenvat credit to the services exporters given the fact that hardly anything is flowing out to services exporters, from the refund tap. A simplified scheme for refunds is being introduced by substituting the entire Rule 5 of CCR, 2004. It is proposed that the new scheme would not require the kind of correlation that is needed at present between exports and input services used in such exports. Duties or taxes paid on any goods or services that qualify as inputs or input services will be entitled to be refunded in the ratio of the export turnover to total turnover. Of course, this would benefit IT exporters to a limited extent, though. While the Department cannot insist on a co-relation between the input services and the services that are exported, the fact remains that the Department is not accepting many services as 'input services' eligible for refunds. So long this critical issue is not sorted out, one would have to keep his hands crossed, on how the new scheme would actually help the services exporters in as much as the Department might continue to hold that most services are not ‘input services’ in the first place.

Before concluding….

The IT Sector, which is currently pegged at around US$ 70 billion, is projected to increase to over USD 200 billion by 2020. This is India’s most promising industry and perhaps, the only sector in which, India can hope to be a global player. The Budget would seem to have dashed the hopes of this Sector, which was, till very recently, one of the most favourite sectors of the Finance Ministry.

The STPI scheme should see a mass exodus as most units which are registered under the STPI scheme would find it not worthwhile to continue under the scheme. This is especially so in the case of companies which have not imported duty free materials. Though the STPI continues to be the certifying agency for services exports of over USD 25,000- per invoice under the FEMA, most units would find it easier to operate out of the STP scheme, both from an economical as well as, a practical perspective.

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