

## FM must extend tax holiday to keep IT Sector away from 'holiday' – June 24, 2009

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**By S Sivakumar, CA**

WITH services constituting about 56% of India's GDP, and with India's services exports projected to overtake the goods exports by 2012, the services sector would need to be looked at differently by the FM. The Information Technology segment, which comprises a significant portion of the overall services sector, has its own unique problems and issues. An attempt has been made to bring some of the most critical issues that concern the IT sector.

The most important expectation from the IT sector, relates, of course, to the extension of the tax holiday under Sections 10A and 10B of the Income tax Act, 1961. While presenting last year's Budget, Mr Chidambaram had hugely disappointed the IT sector by not announcing an extension of the tax holiday for the STP Units, which was originally scheduled to expire on March 31, 2009. Mr Kamal Nath, the then Commerce Minister, had managed to extract a one year extension for the tax holiday, which is now scheduled to expire on March 31, 2010.

One of the main reasons behind the success of India's IT's sector over the years has indeed been the tax holiday which has helped these Companies plough back their earnings and fund their growth, especially given the fact that the banks have been loath to funding IT companies. By not categorically stating anything about the tax holiday over the last two years, the Government, it would seem, has given a lot of hope to the IT sector that the tax holiday would indeed be extended. While the big boys of the IT sector have either already set up or are in the process of setting SEZs, it is the tens of thousands of smaller IT Companies which would feel the pinch, if asked to pay taxes. I would suggest that the FM gives one final extension say, five years, to the tax holiday so that the smaller companies operating as STP Units can better plan their future operations.

The extension of the tax holiday would also help the IT companies to move to the Tier 2 and Tier 3 cities/towns. Given the fact that much of this sector is concentrated on the Tier 1 cities, the Government must look at extending the tax holiday in order to ensure that the benefits arising out of the tremendous growth of this sector is also extended to the Tier 2 and Tier 3 cities/towns.

++ The IT sector has also been suffering heavily due the whimsical interpretation of the transfer pricing provisions by the Income tax Department, especially, over the last two or three years. Most of the Indian affiliates of MNCs have been asked to pay income tax on reworked profits worked by the Transfer Pricing Officers, under Section 92C of the Income tax Act. It could never have been the intention of the Parliament to have the Government collect tax from the STP units, on the basis of the differential profits representing the difference between the unrealistically reworked profits by Transfer Pricing Officers and the profits declared by these companies. This unfortunate situation, which has arisen, due to an over jealous Department and aided by a few Court decisions, would need to be set right by the FM by amending the Income tax Act to provide that, in respect of companies claiming exemption under Sections 10A and 10B, no tax would still be required to be paid on the 'differential profits'.

++ The software sector has been subject to double taxation, in terms of levy of VAT by the State Governments and service tax by the Central Government. There is total confusion on levy of service tax on the sale/transfer of software licenses, which is subject to the levy of VAT. In fact, the FM would need to completely re-visit the definition of 'Information Technology Software Service' contained in Section 65(105)(zzzze) of the Finance Act, 1994. After the rendering of the judgement of the Madras High Court in the Infosys case, which was based on the decision of the Apex Court in the TCS case, more and more

State Governments are seeking to levy VAT on all kinds of software, whether packaged or customized. There is also a lot of confusion on the levy of Countervailing Duty on import of packaged software through the electronic medium, given the fact that the customs rules do not provide for levy of duty on imports not routed thro' the customs station.

The FM would do well to completely revisit the levy of indirect taxes and especially, CVD and service tax on the software industry and help remove the utter confusion that currently prevails. More importantly, the Government needs to understand that software is more about goods than services and that, it is the State Governments that are entitled to levy VAT on software and that, levy of service tax on software leads to double taxation.

++ The FM would need to lend a helping hand, in terms of facilitation refund of service tax for the software exporters. With service tax getting levied on software services with effect from May 16, 2008, software exporters are entitled to apply for refund of service tax paid on input services in terms of Rule 5 of the Cenvat Credit Rules read with the Notifications. Despite repeated circulars and clarifications being issued by the Board, the ground reality remains that the Service Tax Department does seem to be willing to give refunds. IT exporters' refund claims are being rejected by the Department on frivolous grounds and the immediate need is to work towards a system whereby the IT exporters can avail of input services on the exemption mode rather than, on the refund mode.

++ The FM would need to sympathetically look at IT companies which are currently operating as STP units and which are planning to get into SEZs. Due to an amendment to Section 10AA of the Income tax Act by the Budget for 2007-08, in terms of introduction of Sub-section (4), Mr Chidambaram, the tax exemption for SEZ Units is available only if the SEZ Unit is not formed by the splitting up, or the reconstruction, of a business already in existence. The SEZ Unit should not have been formed by the transfer of 80% of the machinery or plant previously used for any purpose. This provision, which could work well for manufacturing companies, would create a lot of trouble for existing IT companies getting into or setting up, SEZs. The concept of plant and machinery which is very relevant for manufacturing companies is largely irrelevant for IT companies. One would expect the FM to exempt IT SEZs from the mischief created by t Sub-section (4) of Section 10AA, which would allow existing STP Units to shift to SEZs as when the tax holiday for STP Units gets withdrawn.

++ Mr P Chidambaram had caused irreparable damage to the IT sector by bringing stock options into the FBT net. Indian IT stars like Infosys are known to have used the stock option route as a tool for intelligently managing the employees' expectations and gaining long term commitments from employees. By bringing stock options within the FBT route, the ex-FM has almost managed to kill the utility of the stock option scheme for corporates and especially for closely held companies. While the idea of scrapping the FBT in toto might not find favour with the new FM, the least he can do is to exempt stock options from the FBT levy and undo the damage which his illustrious predecessor has inflicted on the IT sector.

++ And, lastly, there exists tremendous confusion in terms of the provisions of the Income tax Act governing the levy of tax on non-residents who have been deputed /seconded to India and on residents who are deputed overseas by their Indian employers. It is very common for mid to large sized IT companies to have 'people mobility' both ways and one thing that really drives them crazy, is the methodology of arriving at the tax to be deducted at source. Even though, employees coming into or going out of India are entitled to the benefit of the Double Taxation Avoidance Agreements, the Department till now, has not been agreeing to the Indian Companies considering the DTAA's for purposes of tax to be deducted at source, in terms of Section 192 of the Income tax Act. The result has been that, despite the benefits accruing to the employees in terms of the DTAA's, in the absence of a clear circular or clarification from the Department, the employing Companies do not consider the DTAA provisions while computing the tax to be deducted at source, resulting in an unnecessary requirement of these employees to claim refunds accruing due to the DTAA.

The IT sector has been seeing a good inflow of expats coming to India for jobs and the lack of clarity on the TDS provisions has been working as a dampener, as the additional tax burden is invariably borne by the Indian Companies, pushing their overall personnel costs. A simple clarification from the FM in terms of which, Indian Companies are allowed to consider the DTAA provisions while deducting tax at source under Section 192, would go a long way in further helping Indian IT companies attract the best global talent.

The IT sector represents the only area in which India can hope to play a global role and perhaps, try and match China. The Government would do well to realize that the IT sector has not grown because of the Government, but, despite it. The IT sector is at cross roads now, given the global recession and one would expect the FM to use the Budget as a tool for stimulating the IT sector, which it so rightly deserves. After all, if India can compete internationally on one industry, it is Information Technology.

So, it's up to you, Mr FM Sir.

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