IT Sector pleads for continuation of and clarity in respect of tax holiday under STPI and SEZ schemes – Feb 9, 2011

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GOVERNMENT should extend tax holiday provisions for FY 2011-12

Every other IT (Information Technology, Sir…. not, Income Tax) guy whom one meets these days in Bangalore, India's IT capital, talks of whether the tax holiday provisions would get extended by one more year and what would happen to the tax holiday under the Direct Taxes Code. Many of the medium IT corporates are also very curious about the tax holiday that is applicable under the SEZ scheme and whether, they can shift to the SEZ projects, to be able to continue to avail of the tax holiday. This is not surprising for a sector which has been enjoying tax exemption under Sections 10A and 10B of the Income tax Act, 1961, for a long time now. For the sake of history…..it was Mr Yashwant Sinha, (who, in my view, was one of the most effective Finance Ministers that the country has had), who had announced the availability of the tax holiday under Sections 10A and 10B on a broad basis in the 2000-01 Union Budget.

As things stand now, the tax holiday is set to expire as of March 31, 2011, unless of course, the FM decides to give this one final extension. As is known, the tax breaks for exporters has been in vogue right from 1981 onwards, in one form or other. A significant portion of India's overall exports happens thro' the 100% EOU scheme and there is no denying the fact that, the tax holiday has been a great bonanza for the IT industry, which has been the scheme's largest beneficiary.The scheme has been especially good for the small and medium IT exporters, who have been able to plough back the excess cash and grow their business, thanks to the tax holiday. Though the actual benefit of the tax holiday scheme has been diluted due to the introduction of Minimum Alternate Tax ('MAT') on STP Units with effect from FY 2007-08, the fact that the difference between the MAT and the tax liability is still available for future set off still makes the tax holiday still attractive.

The IT Industry pleads for the continuance of the tax holiday for FY 2011-12, given the fact that, under the Direct Tax Code to be introduced from April 1, 2012, this tax holiday is to be withdrawn. Hence, this is perhaps, the last year that the STP Units would be able to enjoy tax holiday under Sections 10A and 10B of the current Income Tax Act.

Tax holiday under SEZ scheme should be extended to STP Units shifting to the SEZ scheme

As aforesaid, in terms of the Direct Tax Code ('DTC')Bill tabled in the Parliament, it is clearly,*curtains* for the tax holiday for the STP units, with effect from April 1, 2012, the date on which the DTC is supposed to come into effect. With just one year to go for the withdrawal of the tax holiday, the FM would do well to introduce provisions which would enable the STP Unitsto transition to the SEZ scheme and continue to avail of the tax holiday.

There is no denying the fact that, from the point of ease of availing the tax holiday benefit, the STPI scheme is quite unique. Even a small room could be treated as an exporting unit and the STP tax holiday claimed. The STPI scheme has been instrumental in enabling many tiny and small companies to successfully get into software development and use the tax benefits for growth. The only way in which the STP units can avail of tax holiday under the DTC, would be, to go under the SEZ scheme. As we know, the DTC Bill provides that SEZ Units set up till March 31, 2014 would continue to get the tax holiday (which is for a period of 15 years – 100% for the first five years, 50% for the next five years and 50% for the balance period subject to reinvestment, etc.)

But, the process of shifting by the STP units to the SEZ scheme is not going to be easy. Apart from commercial issues like availability of the space, the higher rentals, the fact that SEZs are located far outside the cities, etc., STP units shifting to the SEZ scheme have to overcome the impact of the tax provisions which state that the SEZ Units cannotbe formed by the splitting up, or the reconstruction, of a business already inexistence or by the transfer to a new business, of machinery or plant previously usedfor any purpose. It may be recalled that these provisions had been originally incorporated in the Income tax Act in the 1980s in the form of Sections such as 80-J, 80-I, etc., so to ensure that, units which did not invest in new plant and machinery did not get tax benefits. But, the fact remains that these provisions were largely relevant to the capital goods intensive manufacturing industry. In fact, the very concept of 'plant and machinery' which is applicable to the manufacturing industry is largely irrelevant to the IT industry. It is very unfortunate that the Government has not differentiated between a knowledge intensive industry like IT, from the manufacturing industry and as a consequence, the negative provisions mentioned in the other Sections have also found their way into the Sections governing the tax holiday for the IT Units (10A, 10B, 10AA, etc).

In terms of the STP Units shifting to the SEZ scheme, quite interestingly, the Commerce Ministry, in a communication covered by Instruction No. 70 covered by F.No.12/4/2010-SEZ dated November 9, 2010 has clarified as under:

Quote :

1. Shifting of units to SEZ-

(i) The provisions of SEZ Act, 2005 and Rules framed thereunder do not prohibit transfer of used capital goods or businesses from existing DTA or STPI unit to SEZ. The only deterrent for transfer of such capital goods or businesses is not getting the exemption under Income Tax Act when the value of used capital goods exceeds the 20% of the total capital goods and in respect of businesses no exemption can be availed while the Development Commissioners will be intimated about the transfer of goods/businesses, the final decision regarding the IT exemption will lie with the Income Tax Department. The ratio 80:20 of new : used capital goods shall be reckoned on the date the unit starts to produce goods or services.

(ii) There is no limitation on the transfer of manpower to the SEZ units.

(iii) In respect of the IT companies which operate Master Contracts and which have units in STPIs and DTA etc. and which farm out the subcontract to their various units, they must have an individual and distinct sub-contract in respect of each of its SEZ Units.

(iv) The spirit of the SEZ Act & Rules is that the investment for infrastructure development in the SEZ has to be new. The transfer of used goods/business is only with respect to the SEZ Units.

Unquote :

Given the fact that the concept of capital goods is largely not relevant for the IT, except for computers and networking equipment, it would be very unfair to deny the tax holiday benefits to STP Units based on restrictions which are applicable in the context of the manufacturing industry.

The IT industry would definitely look up to the FM to allow the STP Units to shift to the SEZ scheme and be able to continue to enjoy tax holiday, under the DTC, without any restrictions.

SEZ Units should continue to be exempted from MAT and DDT

Under the current tax provisions, SEZ Units are exempted from the payment of Minimum Alternate Tax ('MAT') and Dividend Distribution Tax ('**DDT**'). The exemption from MAT and**DDT** has been a major feature making the SEZ scheme far superior to the STPI scheme. The DTC Bill however, in its present form, does not exempt SEZ Units from the payment of MAT and DDT. This is a major dampener which could virtually kill the SEZ scheme. Of course, there is absolutely no justification for the Government to require the SEZ units to pay MAT and DDT and this move would also affect the existing SEZ Units.

The IT industry would, of course, expect the FM to ensure that SEZ Units continue to get exemption from MAT and DDT, under the Direct Tax Code which is expected to be introduced from April 1, 2012.

And lastly, FM should intervene to prevent to save the IT industry from transfer pricing nightmare

As we know, the primary purpose behind extending tax holiday for the IT exporters, in termsof Sections 10A and 10B, has been to exempt the taxes on export profits. This very purpose would seem to be in jeopardy, with the Income Tax Department resorting to a highly unjustified interpretation of the transfer pricing provisions and asking STP Units to pay tax on the differential income, i.e the income computed by the Department and the income declared by the Units. It is well know that the Department has been computing the income of STP Units by assuming much higher profit percentages, especially under the cost plus method, by invoking the transfer pricing provisions. Most STP Units have been slapped with very huge tax demands on the differential income and in some cases, the Department has also attached the bank accounts of these units. The basic intention behind introducing the transfer pricing provisions in the Income tax Act has been to prevent the shifting of profits outside India by Indian Companies having international transactions. When the export income is exempted from tax in any case, where is the justification for the Department to invoke the transfer pricing provisions and ask the Indian subsidiaries of foreign corporations to pay tax on the differential 'income'? If there had been clarity in the tax provisions, these companies would have happily declared the higher income and claimed tax holiday in respect of such income, rather than be slapped with attachment notices.It is amazing that there is an absolute lack of clarity on the interpretation of the transfer pricing provisions, even after ten years since they came into the Income tax Act.

The IT industry, which is the worst hit, vis-à-vis the transfer pricing provisions, would expect the FM to ensure, through an appropriate statutory amendment, if required, on a retrospective basis, to ensure that the differential profits, as computed by the Department under the transfer pricing provisions, are allowed tax holiday under Sections 10A and 10B. There is already a judicial precedent for this view, in terms of the Philips Software Centre (P.) Ltd vAssistant Commissioner of Income-tax, Circle 12(2), Bangalore, wherein the ITAT had held that the transfer pricing provisions cannot be invoked in respect of companies claiming tax holiday under Section 10A of the Income tax Act. Unfortunately, this Tribunal has been stayed by the Karnataka High Court, as reported in ***2009-TIOL-324-HC-KAR-IT***

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