PC's Budget delivers a deadly blow to IT SMEs – April 2, 2008

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By S Sivakumar, CA

BUDGET seems to have changed the life of SMEs in the IT sector, forever, with Mr Chidambaram not obliging them by extending the tax holiday under Section 10B of the Income tax Act, which is set to expire on March 31, 2009. For an industry that is predominantly export oriented, the bad news comes at a time when it has already been significantly impacted by the appreciating currency which has seen its margins getting eroded by around 12% over the last months. Added to this are the clear signs of the US economy slowing down, with some people predicting a recession in the coming. The pale of gloom that has descended on this promising industry, post Budget, is then understandable, especially if one had the opportunity to watch the telecast of Mr PC's interaction with the industry leaders, last week. When a CEO asked for the justification of the removal of fiscal subsidies for India's IT industry, when other countries are offering incentives to counter India's dominance, Mr PC was perhaps at his best. When Mr PC pulled out a report to read out that the average tax paid by more than 5500 IT and ITES Companies in India was a paltry 7.35% and that the IT industry should contribute to the country's financial needs in terms of infrastructure development, education, rural development, etc., the questioner's plight was quite understandable. Whatever little hope that the IT industry had had in terms of the tax holiday being extended beyond 2008-09 should have evaporated by now, post this telecast.

The concept of a 'tax holiday' for STPs is however, a bit of a misnomer in as much as the fact remains that they have in any case got to pay Minimum Alternate Tax ('MAT') on their book profits this financial year, which would work out to a cool 10.3% plus surcharge. .

Let's bear in mind that one of the main reasons behind the success of the IT sector in India has indeed been the tax holiday extended to it over the years. Most of IT companies which stated operations in the mid 1990s and the early 2000s were all beneficiaries of the largesse shown by the successive Governments ruling the country in terms of their not tinkering with the tax holiday provisions announced by Mr Yashwant Sinha in the 2000-2001 Budget. Of course, the IT Industry also had the benefit of a depreciating currency which remained at competitive levels right thro' the last 15 years or so. There can be little doubt that these two significant benefits have indeed helped the Indian IT Industry over the years. In fact, till 2006-07 most IT Companies who did not have foreign subsidiaries or branches paid very little tax and this was also mostly in the form of FBT. It is only in the current financial year, i.e. 2007-08 that the real impact of taxes is being felt for the first time by the IT industry after about 10 long years, with these corporates being forced to pay taxes in the form of MAT, not withstanding that MAT is adjustable against future years' regular tax payments.

We could now try and analyse the post Budget scenario, vis-à-vis the larger corporates and the SME corporates. The impact on the larger companies, of course, would be much lesser. Most of these larger corporates are already getting into the SEZ space. Companies like Infosys, Satyam, TCS, Wirpo and Cognizant are already getting into the SEZ space in a big way and we can see this trend accelerating in the coming months. We have also heard that even MNCs are getting into the SEZ space.

Irrespective of whether these large IT corporates are setting up their own SEZs or are getting into SEZs promoted by large developers, the fact remains that the SEZ route will get fully exploited in the coming months. I feel that even subsidiaries of MNCs, who are operating at the SME level mainly as back to back service providers to their parent companies, would also move to SEZs. After all, the tax advantages arising out of the SEZ route are too significant to be ignored. Apart from a 15 year tax holiday, the fact that no sunset clause exists for the setting up of units in SEZs, would mean a lot. This means that the big boys can effectively plan their operations vis-à-vis the SEZ related tax breaks. And, in any case, most of these larger Indian IT corporates do pay income taxes in the countries in which they operate and are in a position to claim the benefits in terms of the Double Taxation Avoidance Agreements.

And, who can deny the fact that the MNCs and the larger Corporates are much better placed to be able to afford the high rentals that prevail in SEZs and to afford to transport their people to SEZs that are located outside the cities? The worst hit would of course, be the smaller and medium companies. Most of these operate in smaller premises located often in the city / urban areas. They wouldn't be able to afford the high rentals that SEZs would charge them and more importantly, most of these corporates do not have their own transport facilities. Transporting out people to far away places on a day to day basis, would be virtually impossible.

While both the big boys and the SMEs would still pay income tax at around 10 to 12% rates for 2007-08 and 2008-09 coinciding with the MAT rates, withdrawal of the tax holiday would mean that the effective income tax rates would go up to anywhere between 20% and 25%%, effective 2009-10. And remember, there is no MAT on SEZs. The big boys would effectively get into a zero tax regime, except for the taxes they pay in foreign countries, which could be anywhere between 5% to 10%. Thus, we will have a scenario wherein the tax differential between the large companies operating out of SEZs and the SME companies that aren't, would work out to anywhere between 15% to 25%, which is very high intra-industry divide, indeed. To increase this divide would be non-income tax issues like non-applicability of service tax in respect of SEZ related activities including, on rentals, etc.

I am not that concerned about the withdrawal of the tax holiday for STPs, per se, as I am, for the fact that the big IT corporates would continue to enjoy tax holiday under the SEZ route while the vast majority of the SMEs wouldn't. As such, even when the tax holiday has been available to all the players, the SMEs are finding the going tough and it is the big boys who have been to grow, all the way. The tax holiday withdrawal would significantly further increase the divide between the big players and the SMEs to the great detriment of the latter.

There could be other developments, as well. IT centric cities like Bangalore, Hyderabad and Chennai could see a significant increase in office space, in terms of the IT specific SEZs being set up in the coming months. And of course, there could be a scramble for the SEZ space, as March 31, 2009 approaches, as more and more STPs would want to get into SEZs. The already existing rental divide between SEZ space and non-SEZ space would only increase. And, in terms of the real estate sector, developers who are in the SEZ space would stand to significantly gain from the increasing scramble for SEZ space as compared to those who are not developing SEZs.

Lastly, even hypothetically assuming that all STPs would want to get into SEZs at some point of time, given the fact that the SEZ is an open ended scheme, I wonder if we would have enough SEZ space to accommodate these STPs. For example, in the case of Bangalore, India's IT capital, there is just not enough SEZ space that is available currently, nor is enough SEZ space getting created to accommodate even a decent number of STPs including MNCs, who are currently operating out of industrial and software parks.

Mr PC's Budget has indeed delivered a deadly blow to the IT-SMEs. Only time will tell as to how many of these corporates would indeed survive, over the next few years, considering also the fact that the advantage of the depreciating rupee which wasavailable over the years, is no longer available to them.

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