Will PC extend tax holiday for EOUs – Feb 29, 2008

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By S Sivakumar

THE IT Industry has always been the blue-eyed boy of the Finance Ministry. Right from Mr Yashwant Sinha and upto our Mr PC, the IT Industry has always been getting what it wants, and in most cases, more than what it wants. Now, this industry seems to be at crossroads, given the fact that the tax holiday extension announced by Mr Sinha in 2000 will not be available beyond March 31, 2009, as things stand now. No doubt then that, this is the most talked about issue in the IT industry. There are very high expectations that the FM would extend the tax holiday for STPs. It would do us good to get a quick recap of the history behind the tax holiday scheme for STP Units, to start with. In the Budget Proposals for 2000-01, Mr Sinha had initially proposed to withdraw the tax holiday benefit under Sections 10A and 10B, in respect of new STP units set up on or after April 1, 2000. As was to be expected, the period between February 28 and March 31, 2000 saw a record number of applications being filed with the various branches of the Software Technology Parks of India and the other approving agencies, for setting up of 'new' STP units. To the relief of all and in response to the appeal of the then charismatic president of NASSCOM, Dewang Mehta, Mr Sinha completely went overboard and amended the Sections 10A and 10B to provide that all new units which are set up even after April 1, 2000, would get the tax holiday exemption, for the balance period, till AY 2009-10, with the total number of years of tax holiday not exceeding 10 years.
Undoubtedly, this was the largest and the longest bonanza that any FM had given to the IT industry, ever. Now, with March 31, 2009 fast approaching, expectations are very high on how the FM will handle this most critical issue facing the IT industry.

As expected, NASSCOM has requested for the extension of the tax holiday under Section 10B for a further period of 10 years. Even the Ministry of Information Technology has asked for the tax holiday extension. Is the request for a further extension of the tax holiday justified, at all? Consider these…….. The tax holiday for 100% EOUs has been in vogue right from 1981 onwards. It is estimated that around 2400 units / companies operate as EOUs, enjoying tax holiday under Section 10A and 10B. It is further estimated that around 20% of India's exports are thro' EOUs, point out to the significant quantum of exporters who are outside of the tax holiday. Of course, in the case of IT industry, a significant portion of the exports is thro' STPs. One strong and oft repeated argument that is advanced by the IT industry is that, Indian Companies would lose their **'competitive edge'** if their export earnings are taxed. A look at the top software exporting companies' performance would confirm the high margins that they have been able to post, despite the severe competition from their global peers. Almost all of the Tier-1 companies have been posting post tax margins in the region of 20% to 30%, if not more, despite all of this talk about global competition, etc. And, interestingly, most of these companies have also been paying taxes in the countries they operate, without any murmur. Now, it would be totally unfair for these companies not to pay taxes in India, while they pay quite a bit of taxes in countries like the US, the largest market for India's software industry. If they are to be subjected to tax in India, on the withdrawal of Section 10B (along with Section 10A), they would still pay minimal taxes, as they would be able to take a credit in respect of the taxes paid in the foreign countries that they operate, on account of the Double Taxation Avoidance Agreements. Let's also keep in mind that the larger players have already created huge financial reserves, given the tax holiday that they have been enjoying over the years. Hence, there is no justification in allowing the large IT corporates to get away without paying corporate taxes, any longer. Mr Narayana Murthy has gone on record saying the Infosys would not mind paying income tax.
Now, where will this proposed withdrawal of the tax holiday leave the small and mid sized IT corporates? There is a lot of talk that the withdrawal would**discriminate these SME STPs vis-à-vis the larger players, who will be able to find alternate models for continuing the tax holiday including, getting into the SEZ space.** There is a perhaps a lot of truth in this, in as much as, the fact remains that all the large software players have either already moved into SEZs or are in the process of setting up their own SEZs or are moving into SEZs being set up by Developers. While I am personally against the tax holiday given to SEZs, especially for a 15 year period, which defies all logic, there seems to be no justification for toeing this line that SMEs will get hit

more badly. True, most large IT companies which are operating as STPs would find ways to shift their exports to the SEZs, which, the SMEs might not be able to, due to a variety of reasons. I see no economic or ethical logic in allowing large IT corporates who, having already made effective use of the tax holiday under Sections 10A and 10B, can now be allowed to go under the SEZ route for another round of tax holiday involving 15 years. For any corporate to get a tax holiday involving tax exemptions for 25 years is something which is devoid of any logic and makes a mockery of the entire tax system. And remember….. most of these large IT corporates would effectively shift most of their exports including exports happening out of their STPs, to the new SEZs being set up, defeating the very purpose of the tax holiday concept for SEZs. One wrong vis-à-vis tax holiday for SEZs cannot be corrected thro' another wrong of extending the tax holiday for STPs and at some point, this logic has to stop. In order to be fair to all concerned, the Government should frame rules to ensure that the large companies are made to pay tax on their export earnings from the STPs post March 31, 2009 and that, tax holiday is given only for the incremental exports arising out the SEZs.

Another argument is that, new investments into the IT sector would not flow in, if the tax holiday is withdrawn. I see no merit in this. No country has ever been able to attract foreign investments on the basis of its tax breaks and India is no exception. Surely, we can't extend the tax holiday on the premise that its withdrawal would slow down new investments.

Another argument is that, Indian IT industry requires more time to mature as a sustainable international competitor. I do not know, how long it would still take India's IT industry and especially the software sector to become 'internationally competitive', as it seems that the tax holiday that it has enjoyed over the years has not already enabled it to become one. It is quitedangerous to argue that a sector can be competitive only on account of tax breaks given to it on a continued basis. This logic has not worked anywhere in the world and this will not work in India, as well. Mr Yashwant Sinha, forreasons best known to him, extended the tax holiday by an unprecedented nine years. If the IT industry has not implemented strategies which should have been made it globally competitive over the last 10 years or so, whose fault is this?

Yet another agreement is that, the tax holiday withdrawal now would discriminate the new companies against the ones who have already made use of the tax holiday. This situation will logically be there any time the Government withdraws the tax holiday as there will always be companies which will get formed after the withdrawal of the tax holiday. Let's keep in mind that, at the time Mr Yashwant Sinha extended the tax holiday, the software exports were around US$ 3.5 billion and this has grown about USD 32 billion in 2006-07. Also remember that a lot of new segments like ITenabled Services have developed in the past few years. The total exports of the IT industry in 2006-07 was around USD 48 billion. **If an industry says that, despite posting a 9-fold increase over a six year period, it still is uncompetitive, something is drastically wrong, somewhere.**

Let's also bear in mind that continuance of the tax holiday under Sections 10A and 10B would be unjustified, vis-à-vis exporters who are not operating as STP units, which as we discussed, constitute about 80% of India's exports. Till 2005-06, there was no discrimination between exporters who were operating as 100% EOUs and exporters who were not, as non-EOU exporters could claim deduction in respect of their export profits under the then existing

Sections 80-HHC (for manufacturing exporters) and 80-HHE (for software exporters), which were removed in a phased manner. The tax deductions under Sections 80-HHC and 80-HHE of the Income tax Act were withdrawn with effect from AY 2005-06 onwards. The Government cannot have different yardsticks for providing tax breaks in respect of the same activity being exports.

And lastly, there is the talk of how the software industry is suffering on account of the appreciating rupee and that, withdrawal of the tax holiday would affect is drastically. This phenomenon is affecting the manufacturing exporters more severely, given their much lower margins. Many large garment exporting units have already shut down their operations affecting tens of thousands of workers who earn low wages. I don't see a need for the IT industry to be treated on a preferential basis, vis-à-vis the appreciating rupee, when all other exporters are suffering to a larger degree giving their thinner margins.

We should also look at the economic cost of this tax holiday. The tax revenue foregone, in terms of the extension of the tax holiday under Sections 10A/10B/10AA/10BA for 2006-07 is estimated at a whopping Rs 12,524 crores, as per Government reports. At a time when there is a strong call is being made for the withdrawal of all subsidies, the tax subsidy of the magnitude that exists in terms of the tax holiday available for STP Units seems unjustified. If the Government raises fuel prices saying it cannot subsidize, is the extension of the tax holiday not a big subsidy to the IT sector?

Can this issue of extension of the tax holiday be looked at from a different angle, which would not affect the Government's tax revenues? Can Mr PC look at the possibility of providing tax breaks / exemptions on the basis of the incremental exports achieved. This concept is not new and had existed in the 1980s when Section 80HHC provided a deduction of 4% on the incremental exports achieved during the financial year, in addition to a deduction based on the overall export sales. This is perhaps the right time to revisit this logic, which would be fair to all exporters, irrespective of whether they operate as 100% EOUs /STP Units or as SEZs or for that matter, as non-STP/SEZ units.

We already have this kind of a concept working in the area of export duty benefits that are given to manufacturing exporters. For a person of Mr PC's calibre, it should not be an issue to devise a workable scheme which would meet his revenue targets and which would also be fair to India's exporting community, which is already suffering from a significant disadvantage in terms of an appreciating rupee, as aforesaid.

Surely, for a sector which has seen a preferential treatment being meted out to it for several years, the withdrawal of the tax holiday would not go well. But, it would seem that the Mr PC might not have much choices, if the latest move of increasing the fuel prices is any indication.

With the proposed date of the withdrawal of the tax holiday about a year away, it would do good to everybody to know where they stand. Either way, the FM should make the Government's intention clear on whether the tax holiday available under Sections 10A and 10B would be extended beyond 2009? This issue would have to be resolved this way or other and cannot be postponed to the next Budget, for sure.

Of course, with the levy of Minimum Alternate Tax on all companies including STP units, the Government is indeed getting some income tax revenues from the IT exporters. But, the bulk of their income still remains exempted, due to the tax holiday.

A tough call, undoubtedly, for Mr Chidambaram.