

Pre-Budget Memorandum 2008

(Direct and Indirect Taxes)

Submitted to Ministry of Finance
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Top Five Most Critical Issues

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Continuation of STPI Scheme beyond 2009

Salient facts:

- STPI scheme has proven to be a big success and a major contributor to the growth of Indian economy (IT-BPO exports :USD 32 billion, 1.6 million direct hires)
- Smaller companies are finding it difficult to rent SEZ space as enough capacity is not always available in the right location. Also, the rentals are very high with developers skimming the cream.
- SMEs cannot be expected to move from their present base to other locations where there are SEZs. Also, BPO companies are now moving to Tier 2 & 3 cities where there are no SEZs.
- BPO is a new and nascent industry with great growth/employment potential. At the same time, competition from other countries is intense, since it does not need any specialised manpower. Therefore, there is a strong case to nurture and support this industry. Extension of STPI is one necessary step.
- STPI enables dispersal of industry permitting entrepreneur to make decision about where to set up business. This spreads wealth and employment.
- For their own reasons, many companies(especially MNCs) do not want to go to SEZ. Their alternative is a location in another country.
- Other countries are offering big inducements to attract MNCs and Indian IT - BPO companies. These include tax holidays, free space, reimbursement of salaries and of training costs etc. Most also have superior infrastructure, resulting in lower operational cost.
- Extension of STPI will provide level playing field between small and big companies, and between India and other countries. It will also help sustain growth of BPO sector.

NASSCOM suggestions:

- Continue the STP scheme and tax incentive under section 10A/10B for next ten years.
- The STP tax holiday removal for IT sector (not BPO) could be linked to the signing of the totalisation agreement with the US government. Even the Kelkar Committee had recommended this. This is a substantial cost for the industry and puts Indian IT companies at a competitive disadvantage when compared to global peers

Broadening the eligibility criteria for Large Tax Payer Unit (LTU) scheme

The current eligibility criteria for LTU scheme is very restrictive and several very large IT companies employing more than 10,000 people and facilitating tax collections of several hundred crores in TDS, Fringe Benefit Tax, Input service tax, customs etc. are not entitled to join the scheme.

Current Income Tax Criteria

The current definition provides that only those companies which have paid Rs.10 crores or more in **advance tax** are eligible

Suggestions:

- Since TDS on salaries and vendors is a statutory obligation cast on companies to ensure efficient tax collections, the eligibility criteria may be expanded to include those companies which make annual remittances of Rs. 50 crores or more as TDS.
- To include payments of self assessment tax, tax paid on assessment, TDS and fringe benefit tax also in the current definition as all these payments are made under Income Tax Act.

Service Tax Criteria

The current definition provides that only those companies which have paid Rs.5 crores or more in service tax are eligible to join the scheme.

Suggestions: The following companies may also be included

- which receive Rs.500 crores or more in revenues by providing services
- which have paid Rs.5 crore or more as service tax on input services

Excise duty Criteria

The current definition provides that only those companies which have paid Rs.5 crores or more in excise duty in cash are eligible.

Suggestions: The following companies may also be included:

- which have paid Rs. 5 crores or more in CVD on imports since CVD is levied in lieu of excise duty
- which have paid Rs. 5 crores or more in CVD on sales made in DTA from SEZ operations since CVD is levied in lieu of excise duty
- which have an annual turnover of Rs.500 crores or more
- which have paid more than Rs.5 crore or more as excise duty, CVD on raw materials

Foreign Tax Credits

Current position:

- a) The Government of India enters into treaty with its counterpart in other foreign countries for granting relief in respect of income taxed in both the countries and for other specified purposes.
- b) Section 90 (2) of the Act provides that where the Government of India has entered into an agreement with the Government of any country outside India under sub-section (1) of Section 90 of the Act for granting relief of tax, or as the case may be, avoidance of double taxation, an option is available to the assessee to apply either the provisions of domestic law or of the treaty law, whichever is more beneficial to him.

Issue:

- a) Though as per Section 90, an option is available to the assessee to apply either the provisions of domestic law or of the treaty law, whichever is more beneficial to him, the domestic law itself does not a provision to grant relief of tax against double taxation. Therefore, the assessee has no option but to apply the provisions of treaty law.
- b) There exists some inherent inefficiency in treaties entered into with some countries concerning credit for foreign taxes. The objective of the tax treaty is not served well unless the taxpayer gets full relief to the extent of the tax paid on income in the other country. Though the intent is very clear, the language used in some of the treaties does not support such intent. Certain major treaties like the one with Canada, UK etc., provide a very restrictive tax credit. For instance, Article 23-3 of the Double taxation avoidance agreement (DTAA) between India and Canada reads as follows:

“The amount of Canadian tax paid, under the laws of Canada and in accordance with this Agreement, whether directly or by deduction, by a resident of India, in respect of income from sources within Canada which has been subjected to tax both in India and Canada shall be allowed as a credit against the Indian tax payable in respect of such income but in an amount not exceeding that proportion of Indian tax which such income bears to the entire income chargeable to income tax.” (Emphasis supplied)

Even the full credit on the “doubly taxed income” is not allowed in such cases. Credit is allowed only as a proportion of the income taxed in the foreign country on the total income of the assessee.

Recommendation:

It is suggested that relevant provisions are incorporated in the domestic law to provide a mechanism for allowing full tax credit.

Advance Pricing Agreements (APA) to provide upfront tax certainty

Similar to the existing mechanism for issuing advance rulings to provide certainty on issues of tax interpretation and principles, we urge the Government to set up a mechanism for advance pricing agreements on transfer pricing issues. This will provide much needed tax certainty and avoid protracted litigation against transfer pricing adjustments at the field level. It may be noted that following countries already have this as part of their tax legislations:

- United States, Canada and Mexico
- Almost every European country
- China, Taiwan, Korea, Japan, Australia

This also gives an opportunity to government to review and analyse all business facts, risks and circumstances upfront rather than waiting for 4-5 years by the time the assessment of tax return is started.

We strongly suggest that such an APA mechanism be included in the next Indian budget and that resources be provided to the new APA office to allow them to process the required rulings.

Refund of service tax paid on services utilized for export of computer software and BPO services

- The service tax on input services consumed in software and BPO business amounts to around 3% of business cost, which is a significant number when Indian companies have to compete in international market
- Denial of service tax refunds to software exporters on the ground that software is exempt from service tax is not justified since export of even taxable services anyway is exempt
- No refunds granted even to BPO service exporters on technical/practical interpretations and litigative approach
- Parity to be maintained between export of goods and services and also between services (taxable or non-taxable).
- Field should be instructed to grant refund of input service tax used for export of non taxable services.
- Many countries like UK, Ireland, China, Singapore etc have a provision for refund of input taxes.

Critical issues requiring urgent attention of the Government through Board Circulars and Clarifications

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100% tax holiday benefits for units in SEZ: Aligning the provisions of Section 10AA

Current position:

SEZ units setup by existing companies will not get 100% Income Tax exemption as Sec 10AA(7) restricts the benefit as a proportion of SEZ unit turnover to entity turnover

Issues:

- Reduces tax exemption benefit for SEZ units as the formula for calculating benefit considers the proportion of the SEZ turnover to the entity turnover. Hence, existing companies setting up new units in SEZ will not get 100% Income tax benefit on export profits.
- Existing companies are forced to form new legal entities for each SEZ units to avail the income tax benefit. This will result significant administrative and operational challenges in managing multiple companies.

Suggestions

The language of Sec 10AA (7) needs to be amended in the following manner:

*“the profits derived from the export of articles or things or services (including computer software) shall be the amount which bears to the profits of the business of the undertaking, being the Unit, the same proportion as the export turnover in respect of such articles or things or services bears to the total turnover of the business carried on by the **assessee undertaking**”*

The replacement of “assessee” with “undertaking” will bring 10AA benefit in the exact manner as 10A benefit.

FBT on ESOP

The Fringe Benefit Tax on stock plans of companies was levied recently in-lieu of income tax payable by employees on their profits. Apparently, it was done to check against any possible tax avoidance by employees and/or to tax the capital gains on shares of companies listed in India. The law also allows recovering the tax amount from employees in full.

For all practical purposes, it is a surrogate income tax, collected as FBT from employer as a matter of administrative convenience and employer in turn has a right to recover from the employees.

The current rules have substantially increased the tax cost for the foreign employees working in India and Indian employees working outside India as no foreign tax credit is available for a tax other than income tax.

There is an ambiguity whether recovery of FBT from employees will be treated as an income in the hands of employer while no deduction is granted for FBT payment.

The current valuation guidelines do not provide clarity on shares of foreign companies granted to the employees of Indian subsidiaries and branch offices of these foreign companies.

The current mode of levying Fringe benefit tax on stock options in the hands of the employer creates an issue for the employer since the recovery of the FBT is not EPS neutral. While the FBT liability is regarded as a charge to the income statement, its recovery from the employees is regarded as a capital contribution under the accounting regulations. Thus, the employer has to take a charge for the FBT liability, even though from a cash flow perspective he may have been able to pass on the charge to the employees.

Another issue with this employer-based levy is that the recovery of the tax from the employees is not regarded as a creditable foreign tax in the hands of expatriates based in India as far as their home country tax returns are concerned. This leaves the India based expatriates with a tax liability as high as 60 – 65% in respect of the gains derived from the ESOPs.

Another issue is in the case of stock options granted by a foreign company to employees of its Indian branch / subsidiary which are governed by the stock option agreement executed between the foreign company and employees of the Indian branch / subsidiary. Such agreements provide only for deduction of withholding tax by the employer and do not provide for recovery of FBT. If the FBT is to be recovered from the employee, prior written consent from employees is required, else

it will amount to a breach of contract. It is difficult to obtain such written consent from each employee. It is also likely that some employees will refuse to provide such written consent. In such cases the tax burden will fall upon the Indian branch / subsidiary without giving the branch / subsidiary any recourse to recover the same from its employees.

In order to circumvent the above issues, we recommend considering the following clarifications:

- FBT on stock plans is income tax only for the purposes of relief/credit in terms of various tax treaties India has signed with other countries and that employee does not need to pay any further tax on his gains already taxed as FBT.
- A clear statement either in the rules or circular to state “the primary obligor for FBT is the employees. However, for convenience of collection, the same has been placed on the employer”
- Recovery of FBT from employees will not be taxable in the hands of the employer to the extent of FBT payment made in this regard.
- The current valuation guidelines may be broadened to include the shares of foreign companies listed on international stock exchanges
- The law provides for recovery of FBT from employees. However, accounting regulations does not allow the recovery to be accounted as EPS neutral.
- In case of ‘same day sales’ of stock options granted by a foreign company to employees of its Indian branch/subsidiary, it would be sufficient compliance if the employer ensures that the FBT is paid by the employee either through payroll deduction or through advance tax.
- For administrative convenience and to plug any revenue leakage, the employer could be held responsible for collection of FBT from the employee and its deposit with the tax authorities (similar to withholding tax in case of salaries).

Deduction of Tax at Source from payment to Non-Resident under section 195.

As per the provisions of section 195 tax is deductible from payment to non-resident only if such sum is **chargeable to tax under the provisions of the Income Tax Act, 1961.**

If the person making such remittance considers that the whole of such sum is not chargeable to tax, then as per the provisions of S. 195(2) he can make an application to the jurisdictional assessing officer for determination of sum chargeable to tax (No Objection Certificate).

However, Circular No. 10/2002 dated October 9,2002 issued by the Central Board of Direct Taxes gives an option to obtaining the No Objection Certificate from the income tax authorities for remittances to non- resident. As per the said Circular, remittances are allowed to be made without insisting upon a NOC from the "Department" provided the person making the remittances furnished an undertaking and a certificate from Chartered Accountant in the prescribe format.

The Reserve Bank of India issued Circular No. RBI/2007-08/100.A.P. (Dir.Series) 03 dated July 19,2007 extending the above process to all remittances in foreign exchange including those *in the nature of trade transactions such as import payments.*

Since the law requires such process to be followed only for determining portion of remittance which will be chargeable to tax in India, these procedural requirements as circulated by the CBDT as well as the RBI has created lot of confusion in the industry in addition to creating avoidable administrative burden on the industry.

Recommendation:

- 1. It shall be clarified that the NOC process may be followed only in respect of remittances, which the remitter considers as chargeable to tax.*
- 2. The RBI Circular No. 03 dated July 19,2007 shall be withdrawn.*

Rationalisation of transfer pricing rules

Current position:

As per *Rule 10B(4)* of the Income Tax Rules, 1962, while benchmarking a transaction or a group of transactions, taxpayers have been given an option to use data relating to earlier two years in cases where such data has an influence on the determination of transfer pricing.

However, the acceptable international practice for comparability of transactions is to use the multiple years data ranging from three to five years so as to neutralise the effects of business cycles, changes in economic conditions, etc.

Recommendation:

- Provide for presumptive/ pre-determined levels of profits (safe harbor rules) for various types of business activities low end activities. This would give a choice to tax payers to get tax certainty and avoid litigation.
- allow the use data relating to the previous three-five years,
- allow an inter-quartile price range (instead of the arithmetic mean)
- not to deny the deduction under Section 10A / 10B, on account of TP adjustments,
- align the penalties to international standards and thereby reduce the rigor,
- clearly specify that transfer pricing provisions will apply only to “cross border transactions”
- clearly provide the priority within the three methods for determining transfer price as per international norms.

Consolidated Tax Return

Current position:

- a) Business may be organized as a single entity or through one or more subsidiary companies due to commercial, strategic and regulatory reasons. The practice of carrying on business through subsidiaries and affiliates is common in the following circumstances:
 - i) Where there is a business necessity to focus and leverage on the strengths of each separately identifiable business.
 - ii) Where the human resources requirements across businesses are not uniformly the same.
 - iii) Where the strategic minority shareholders having confidence in one line of business are unwilling to spread their risks to other lines of business.
 - iv) Where having regard to the nature of business, it is necessary to comply with the special regulatory requirements.
- b) However, even though the business is organised through subsidiaries, the same management exercises control and supervision over all businesses.
- c) Having regard to the above, mandatory accounting standards notified under Section 211(3C) of the Companies Act, 1956 require presentation of consolidated accounts of all the entities in the group for each accounting period.

However, tax laws do not allow consolidated filing of returns.

Issue:

In the present system, losses of a business carried on by a subsidiary are not available for set-off against profits of business carried on by the holding company or by other subsidiaries. Therefore, there exists greater inefficiency and immobility in the structuring and conduct of business operations. It was way back in the 1910s that the United States adopted consolidated tax filing. Many other countries like Germany, Japan, France etc., also have provisions enabling consolidated tax filing.

Recommendation:

In recent years, provisions were introduced in Income tax Act also to enable business re-organisations in a tax neutral manner. These provisions do give the much needed flexibility and freedom for the Indian businesses to meet with the borderless competition. Introduction of a system of consolidated tax returns for group entities will be a major step forward in this direction.

It may be noted that introduction of a system of consolidated tax returns will yield the following benefits:

- This will eliminate the economic distortions on account of inter-company transactions within the group and thereby ensure reduction in tax avoidance practices like intra-group dealings, loss cascading and value shifting.
- Tax effects on the dividends paid between companies will be eliminated.
- Currently, the loss of a business carried on by a subsidiary can be set-off against the profits of the holding company or any other subsidiary only through an amalgamation covered by Section 72A of the Act or demerger as defined in Section 2(19AA) of the Act. Consolidated tax return will bring in these benefits and will save precious time of the judiciary in approving such re-organisations.
- Also, substantial administrative resources are spent on assessing various entities of the same group. Consolidated return filing will assist in simplification of the tax system, resulting in both reduced cost on ensuring taxpayer compliance and administration, and strengthen the integrity of income tax system. It will also save precious time and effort for tax administration, which could be re-directed towards increasing the taxpayer base.

Import of Services

Rule 2(1)(d)(iv) of the Service Tax Rules inserted by the Service Tax (Amendment) Rules, 2002 w.e.f. 16th August 2002 fastened the liability to pay service tax to the *recipient of services in India* in relation to services provided *from outside India*.

However, since Rules are only subordinate legislation and can not go beyond the principal legislation, the said Rule was perceived to be inoperative.

In order to give the above Rule statutory validity and to make it operative, Section 66A was inserted by Finance Act, 2006 w.e.f. 18th April 2006 simultaneously substituting the said Rule w.e.f. 19th April, 2006 by the Service Tax (Second Amendment) Rules, 2006 making the *service recipient in India* liable to discharge service tax liability on services *provided from outside India*.

Despite this legal position, many service recipients are issued Notices to discharge the liability as a *service recipient* from August 16th, 2002 to 18th April, 2006, under the old Rule 2(1)(d)(iv) This tax is sought to be collected without any authority of law.

Recommendation: Suitable clarification shall be issued making service *recipient* in India liable for services provided from outside India only from the date of insertion of Section 66A, i.e. w.e.f. 18th April, 2006.

Specified Services

Rule 6 (5) of the Cenvat Credit Rules, 2004 provides that full tax credit will be allowed on the following services (known as Specified Services”) when they are used as input services, unless such service is used exclusively in or in relation to providing exempted services:

- Architect’s Services
- Banking and Financial Services
- Commercial or Industrial Construction Service
- Consulting Engineer’s Services
- Erection, Commissioning and Installation Service
- Foreign Exchange Broker’s Service
- Insurance Auxiliary Service
- Intellectual Property Service
- Interior Decorator’s Service
- Management, Maintenance or Repairs Service
- Management Consultant’s Service
- Real Estate Agent’s Service
- Scientific or Technical Consultancy Service
- Technical Inspection and Certification Service
- Technical Testing and Analysis Service

The list of such specified services has not undergone any change since its introduction and needs to be reviewed periodically to include services which are newly made taxable e.g. the service of “Renting of Immovable Property” made taxable w.e.f. 1st June 2007.

Recommendation: It is recommended to include the service of “renting of immovable property” in the list of Specified Services to allow full tax credit and also that effective mechanism shall be put in place to periodically review and update the list of Specified Services.

Procedural requirement for Export of Software

In respect of “on-site” software consultancy, the SEZ Rules 2006 -Rule 46(3)(ii) require submission of the following details to the authorized officer:

- the contract or the purchase order,
- foreign exchange remitted,
- persons deputed abroad.

The performance of the SEZ Unit is monitored on an Annual basis for which each Unit is required to submit Form I duly certified by a Chartered Accountant. The Form I give details like exports and imports during the year, sales into domestic tariff area, the net foreign exchange earnings, receivable in foreign exchange etc.

Consequently, the procedural requirement does not add any further value in judging the performance of the Unit.

Recommendation: The procedural requirement needs to be **retrospectively** deleted.

Taxation of Services (Provided from Outside India and Received in India) Rules, 2006

In order to bring the provisions of Taxation of Services (Provided from Outside India and Received in India) Rules, 2006 (*hereinafter referred to as said 'Rules'*) in line with the parallel provisions under the Export of Service Rules, 2005 as amended vide Export of Services (Amendment) Rules, 2006, following suggestions are placed for consideration:-

Recommendation:

After Rule 3 (iii) of the said Rules, following *provisos* shall be inserted:-

Provided that where such recipient has commercial or business establishment in the country in which the provider of the service is located, such taxable services as provided shall be treated as import of service only when order for provision of such service is made by the service recipient from any of his commercial or business establishment located inside India.

A further *provisos* shall also be inserted as under:-

The provision of any taxable service shall be treated as import of service when the following conditions are satisfied, namely:-

- a. such service is delivered inside India and used inside India; and
- b. payment for such service provided inside India is received by the service provider in convertible foreign exchange.

(2) Rule 5 of the said Rules, specifically provides for not treating the taxable services as output services for the purpose of allowing credit of service tax paid on any input services under CENVAT Credit Rules, 2004. This specific provision is contrary to parallel provisions under the Export of Service Rules, 2005 which provides for rebate of service tax.

Recommendation: To correct the anomaly, suitable amendment shall be carried out in the said Rules to give effect to the following:-

Taxable service provided from Outside India and Received in India shall be treated as an 'Input Service' within the meaning assigned to it in clause (l) of Rule 2 of the CENVAT Credit Rules, 2004 so as to enable the service recipient to avail credit of service tax paid on such taxable services provided from outside India and received in India when used by the service recipient in India for providing taxable output service.

The Central Govt. may by Notification allow such CENVAT credit subject to such conditions & limitations, if any, and fulfillment of such procedure as may be specified in the Notification.

The service tax (determination of value) Rules, 2006:

The valuation under excise has slowly transformed from the concept of 'notional value' to 'transaction value'. The concept of transaction value was introduced with effect from 1/7/2000. The new section 4 essentially seeks to accept different transaction values which may be charged by the assessee to different customers, for assessment purposes so long as these are based upon purely commercial consideration where buyer and seller have no relationship and price is the sole consideration as per commercial practices rather than looking for a notionally determined value.

In contrast to the aforesaid principle the concept of notional assessable value was brought into the service tax stream by introducing Service tax (determination of value) Rules, 2006 wherein various methods are prescribed to ascertain notional value of a particular service transaction.

The aforesaid rules should be suitably modified bringing transaction value into the service tax levy in line with excise.

Other key issues

- Carve out a separate category of services called “Information Technology Services” and remove IT services from all other headings.
- Administration of Service Tax only through registered authority
- Clarify the scope of Manpower Recruitment or Supply Agency’s services” to exclude services which are essentially “technical assistance in the discipline of computer software engineering”.
- Clarify that software maintenance is “technical assistance in the discipline of computer software engineering”.
- Align service tax exemption available to SEZ unit / developer to units in STPI / EOU.
- Notify IT / ITES industry as a class of category of persons eligible to make an application for Advance Ruling under Section 96(1).