



India Service Provider Tax Holiday End Draws Near: Cause for Concern?

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INTRODUCTION

The Software Technology Park India (STPI) scheme was introduced in the formative years of the information technology (IT) industry in India. It provides certain concession in duties, levies and taxes to companies that export IT and IT-enabled services. These include exemptions from customs and excise duty, as well as reimbursement of Central Sales Tax. However, the largest concession is the exemption from corporate tax for the initial ten years, from when a business “unit” is set up, all being subject to certain provisions of the Indian Income Tax Act.

This initial ten-year tax holiday helped the fledgling industry grow rapidly as companies churned back earnings into investments in expansion and growth. Several of the older and more established players, such as Infosys, TCS and Wipro, continue to derive the benefits of this corporate tax exemption by establishing new units, a practice which helps them reset the clock on the ten-year tax holiday for those units.

BENEFICIAL EFFECTS

The beneficial effects are fairly obvious. These concessions not only contributed significantly to the massive success of the Indian IT services industry but also resulted in an extremely beneficial downstream impact on the overall economy and the extended ecosystem of which the Indian IT industry is a part. Indian IT and business process outsourcing (BPO) services companies are extremely profitable and some are stock market pinups. Several allied and ancillary businesses have also

boomed, as a result of this enormous expansion in the IT and BPO services business. Education, real estate, local transportation and a host of other retail services are merely a few at the top of a long list of segments of the Indian economy that have surfed the same wave.

However, like other holidays, this great holiday is gradually coming to an end in 2009, according to current legislation. This year (Financial Year: April 2007 — March 2008) the Indian government has introduced new tax provisions that require companies that have been enjoying such benefits to pay a Minimum Alternate Tax.

EMERGENCE OF THE SPECIAL ECONOMIC ZONES

In the meantime, the government of India has introduced the Special Economic Zones Act 2005 which provides a 15-year tax holiday for units set up within the approved Special Economic Zones (SEZ). The tax exemption is to the extent of 100 percent for the first five years, 50 percent for the next five years, and up to 50 percent for last five years in the 15-year period, subject to certain conditions. Currently, this scheme is open-ended unlike the STPI scheme, which is set to expire in 2009.

Many of the Tier-1 and Tier-2 Indian heritage IT service providers are setting up SEZ units and are also actively lobbying for the extension to the STPI scheme based tax holiday beyond 2009. While the overall socio-economic benefits of these various schemes are currently a subject of public debate in India, the net impact to service providers is a



definitive increase in tax outflow, the quantum of which will vary, depending on how well they leverage these available concessions.

DOES THIS CHALLENGE THE VIABILITY OF INDIAN HERITAGE SERVICE PROVIDERS?

The answer is clearly, “No.” Yes, this will certainly lead to a reduction in the providers’ net margins. In fact, most of the Indian heritage service providers are potentially looking at reductions of five to ten percentage points (depending on how much tax they currently pay) from their current net margin levels, which are in the range of 20 - 28 percent. This indicates that the holiday is clearly over, but it also tells us that they are not exactly returning to a life of hardship and toil. With expected net profitability percentages still in the high 10s or low 20s, this is well above the margins that their global peers, such as the Big Six (i.e., ACS, Accenture, CSC, EDS, HP and IBM).

WHAT DO WE SEE IN THE MARKETPLACE?

When dealing with Indian heritage service providers, TPI has occasionally witnessed some of these firms adopting negotiating positions that involve the inclusion of protective provisions, which demand the right to pass on the tax impact in the event of a change occurring to the prevailing tax holiday.

WHAT DO WE ADVISE OUR CLIENTS?

While pricing decisions are strategic and market-driven, service providers typically approach pricing from the point of view of defined target ranges for gross and operating margins. Client engagement executives and operating managers are often measured on the profitability of the account from an operating margin perspective. There are several direct and operational cost elements that determine these gross and operating margins and

hence directly impact price. Some of these are labor, facilities, SG&A, as well as taxes, including GST or service tax that hit revenue directly. However, other income statement cost elements, such as taxes on income, interest, depreciation and amortization, are contingent on the service provider’s capital structure as well as prevalent tax laws.

Therefore, the future impact of taxes on income generated by the service provider should not be a consideration when drawing up the financial provisions of a sourcing contract. In a competitive marketplace, service providers need to be cognizant of and creative about working within the constraints imposed by the tax and regulatory environment and have an optimal capital structure to support fixed assets and other balance sheet items that have a depreciation or amortization impact, to be able to manage net margin expectations of capital markets and investors. The inclusion of such provisions in sourcing contracts, which results in clients absorbing the tax impact either partially or fully, is decidedly undesirable.

CONCLUSION

While the tax holiday that Indian heritage service providers have enjoyed is evidently nearing its conclusion, this does not impact their attractiveness or viability as long-term sourcing business partners. Furthermore, the government of India has introduced other favorable tax regulations which these players can beneficially leverage. Clients establishing initial or renewed contractual relationships with these service providers should avoid the potential inclusion of unfavorable financial provisions related to sharing the impact of future changes in taxes because of the tax holiday coming to a close.



ABOUT THE AUTHOR: Mr. Sebastian advises TPI's clients on aspects of their global service delivery. With extensive experience advising clients on their sourcing strategy with specific focus on India, Thomas provides strong operational experience, a deep understanding of technology businesses, and a valuable network of relationships in Indian IT outsourcing and BPO. His knowledge derives from practical experience that includes a broad spectrum of exposure in various functions and businesses in the IT services industry. This experience includes managing the complete project life cycle and managing client relationships within large enterprise accounts. Thomas is the author of India Engineering Centers – A Planning Guide – a well researched paper detailing the critical success factors and requirements for setting up an India Engineering Center, based on the experiences of several multinational technology companies and Silicon Valley startups.

Immediately prior to joining TPI, Thomas worked in the venture capital industry focusing on investments in communications, semiconductor, software and services.

Thomas holds a Bachelor of Technology (Honours) in Electrical Engineering from the Regional Engineering College in Calicut and a Master of Business Administration from XLRI in Jamshedpur, India.

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ABOUT TPI: TPI is the founder and innovator for the sourcing advisory industry, and the largest sourcing advisory firm in the world. We are expert at a broad range of business support functions and related research methodologies. Utilizing deep functional domain expertise of accomplished industry experts who possess extensive practical experience, TPI collaboratively works with organizations to help them optimize their business operations through the best combination of insourcing, offshoring, shared services and outsourcing. For additional information, visit www.tpi.net.

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