Taxation Trends and its impact on Indian Multinational Companies

S. Mahalingam

FORUM
OF FREE ENTERPRISE

> *"Free Enterprise was born with man and shall survive as long as man survives".*
>
> **- A.** D. **Shroff**
> Founder-President
> Forum of Free Enterprise

INTRODUCTION

The Forum of Free Enterprise has pleasure in placing in your hands yet another booklet based on an excellent inaugural speech delivered by Mr. **S.** Mahalingam at the Forum's Annual three-day residential programme on "Current Issues in Direct and Indirect Taxation" in August 2011.

The contents of the booklet, coming from a Chartered Accountant who is also the CFO and Executive Director of Tata Consultancy Services, makes it highly educative, interesting and informative reading.

Kanu H. **Doshi**
Hon. Treasurer
Forum of Free Enterprise
(Joint Programme Director; Forum's Annual Residential Programme for Company Executives, Professionals and others, 2011)

Taxation Trends and its impact on Indian Multinational Companies

by

S. Mahalingam*

It is indeed a great honour for me to address a programme organized by the Forum of Free Enterprise – an organization which is so closely linked to Mr. Nani Palkhivala. Like many Indians of my generation, I have always admired the multifaceted personality of Mr. Palkhivala. He was the Founder Chairman of Tata Consultancy Services (TCS) which was started as a Division of Tata Sons Ltd. in 1968, He continued in that role until 1996, except for a short period between 1977 and 1979 when he went as India's Ambassador to the US, I have had occasions to interact with him during that period on TCS matters, He was proud of what we were achieving in TCS and he always took the ethically right view in business discussions. And he was a towering personality. I had experienced the power of his name in 1992 when I had to deliver a letter from him, in his capacity as the Chairman of TCS, to the Chief Minister of Tamil Nadu who coincidentally is the current Chief Minister of Tamil Nadu – Miss Jayalalitha. This was a letter which laid out the growth plans for TCS in Tamil Nadu and I wanted it delivered to her unopened. The Secretary to the Chief Minister said that only letters from the Prime Minister and President of India are sent to her unopened and I said it was from Mr. Palkhivala. He readily accepted that the letter from this towering personality will be sent to her unopened, And the Chief Minister replied to him, in her own hand, immediately.

I had the privilege of being associated in the organization of public meetings at Madras where he delivered his hugely popular speeches. Besides the budget speeches, he spoke at Theosophical Society on "Man - Past, Present and Future" where his subject was largely philosophical. He gave a Prof, Devanesan lecture on Higher Education. One of the most memorable speeches, which was totally spontaneous, was at the Sankara Netralaya, where he went accompanied by Dr. Badrinath on an impromptu invitation.The speech I heard was enthralling; I was also witness to his charitable instinct , especially giving to causes without any self publicity. I was also fortunate to be involved in another facet of his interest – He was the Managing Trustee of Veda Pata Nidhi Trust, which he took up at the behest of the former Sankaracharya of Kanchi, After his passing away, a number of prominent citizens of Chennai who had interacted with him and benefitted by it, decided to start a foundation in his name. I am a trustee of this foundation and I am also a Director of Nani Palkhivala Arbitration Centre, which has been promoted by this foundation. He was a great jurist and it is because of the power of his advocacy that we are living today in a Free India, As Chairman of TCS, he laid the foundation for the immensely successful software industry, he shaped the minds of men towards liberalized governance, he was the champion of India in external fora and he had deep involvement with India's priceless cultural heritage.

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* *The author is CFO and Executive Director, Tata Consultancy Services. The text is based on the inaugural address at the Annual Residential Programme on "Current issues in Direct and Indirect Taxation" arranged by Forum of Free Enterprise in August 2011 at Khandala.*

I was wondering what I should speak on when I was requested by Mr, Kanu Doshi to inaugurate this residential programme. As I see from the programme, you will be debating the tax issues and I do not want to burden you with my own analysis. I will speak on how the IT industry is affected by the emerging tax issues and how its business is being shaped by these issues,

The IT Industry brought globalization to Indian companies. They were perhaps the first instance of creation of Indian multinationals. While we battled against the controls of the "license raj" in the years upto 1991, the tax administration was benevolent towards this industry. It was difficult to import computers into India, even when it was to be used for software exports. It was a herculean task to arrange foreign exchange allowances for people deputed abroad on assignments. There were number of procedural problems in clearing magnetic tapes, which would be either inputs or outputs to a software export assignment, But we had tax breaks, either due to Section 80 (0) where fully or partly, the export profits were excluded from taxation. The benefit later came through Section 80 HHE. I had gone on a tour of US with the late Pramod Mahajan in 2001 when he remarked in a public speech there that India did well in IT and Beauty because of the benign neglect of these sectors by the government. I do not know about Beauty, but IT did well in spite of the government attention.

Whether due to neglect or not, we have continued to grow and the main companies were projected to have a sales turnover of over ₹ 400,000 Crores in the last financial year which ended in March 2011. The industry directly employed over 2.5 million people. The multiplier effect has been phenomenal. It has spawned off many support industries, such as catering and bus and other local transportation.

When we see new townships coming up to cater to the needs of IT professionals, we grasp the extent of economic impact that this industry has had on India. This remarkable growth has been in the post liberalization era. Mr. Palkhivala had talked about India progressing rapidly when it releases the animal instinct of entrepreneurs and this industry is a living proof of his belief.

I want to give you some details about my company Tata Consultancy Services as my speech is largely around the issues that I, as the Chief Financial Officer, keep facing. TCS has operations in 42 countries, including in India. We not only employ people in India but also overseas, Out of a total staff strength of nearly 200,000 employees at the end of June 2011, we had over 14,000 persons who were recruited overseas. We have 54 subsidiaries, including Indian subsidiaries. In the total of 54 subsidiaries, we had 20 direct subsidiaries, with the remaining as step down subsidiaries. We have registered branches in 24 countries. We operate through both branch and subsidiary models for our operations. We opened subsidiaries overseas because of specific situations in some of these countries. In some cases, the visa processing becomes easier if the request comes from a local subsidiary. Some contracts, notably from the Government, will not come unless the contract is with a locally incorporated entity. In some cases, due to data privacy laws or specific programmes such as Black Empowerment in South Africa, you need locally incorporated entity carrying on the business. In some countries where Indian business has no prior experience of operating, it would be better to shield the parent company in India from the local regulations. Also when we acquire companies overseas, we may not be able to fold them into the parent company due to certain acquisition related issues. While branch would be more efficient from the total tax point of view in view of the exemptions in India, we may have business reasons to have overseas subsidiaries.

The extensive operations overseas introduce transfer pricing issues, 90% of our revenues are international revenues and accrue in 80 countries. ***55%*** of our costs are incurred overseas. The subsidiaries overseas have substantial responsibilities - they sign contracts with the customer and take all the risks associated with execution of such contracts. These risks include selling, marketing, credit, delivery, legal, employee and other risks related to a typical business entity. The tax authorities overseas see the substantial nature of their operations and the risks that they take and they benchmark it against similar companies. An independent action by Indian tax authority to assign a different character to such business entities will only lead to substantially higher taxes in both jurisdictions - it would also lead to double taxation. An institutional mechanism in the tax department to resolve disputes through Disputes Resolution Panel (DRP) has not borne fruit. I have said in some public speeches that the only way through which DRP will act independently will be if the department is allowed to go on appeal.

Another Institutional mechanism to resolve these disputes is the Mutual Agreement Procedure (MAP). This is an alternative mechanism incorporated into many tax treaties for the resolution of international tax disputes. Resolutions of the disputes happen through the intervention of the Competent Authorities of each State who evolve a mutually acceptable solution. I think the discussions at MAP will test the openness with which authorities would approach this forum. I would like to particularly emphasize the role of Indian authorities in these matters as they need to take a balanced approach, appreciating the impact any decision will have on India headquartered multinational corporations.

I have dealt with Transfer Pricing issues as they are becoming very critical for multinationals like us. It is well recognized that transfer pricing is not an exact science. There is bound to be differences in the ways tax payers and tax authorities evaluate arms length price for the transfer of goods, services or intangibles. Surveys conducted on the various aspects of transfer pricing show that growing number of countries are directing attention to transfer pricing with transfer pricing audit becoming a major cause of concern for tax payers in almost all jurisdictions across the globe. Direct Tax Code (DTC) has made provision for Advance Pricing Agreement (APA). This is a contract, usually for multiple years, between a tax payer and at least one tax authority specifying the pricing method that the tax payer will apply to its related company transactions. The effectiveness of APA will depend on the simplicity, transparency and time frame for administering the process. A number of advanced countries have made this effective in order to attract investors. Certainty of cost, reduced litigation and business stability are major advantages for the business community. While DTC talks of unilateral APA, there is urgent need for suitable provisions for bi-lateral APA in order to ensure finality of costs - this is particularly required for Indian MNCs like TCS operating in large number of countries all over the world.

While I have dealt with the aspect of resolving a tax demand issue, I would like to take this one level up on how it impacts the business model. Implicit in the tough stand of the Indian tax assessing officer is that IT outsourcing is an easy business which can be handled remotely in India without a strong and contractually involved organization overseas. This attitude was perhaps alright when customers overseas were coming to small IT operators in India for hiring skilled people and position them on-site, popularly known as 'body shopping'. The reality is that all the premier IT companies have created strong international capability and the customer overseas experiences the value of the Indian Software Company through provision of solutions and not skilled manpower. There are business and regulatory knowledge which only highly qualified local employees overseas will have. Also, in view of worries in advanced countries like the United States on jobs migrating to countries like India, we need to enhance the capabilities in the overseas subsidiary companies through recruiting experts who have knowledge of Industry and Technology domains, Relationship capability and skills in Project Management and Implementation services. When the Indian Authorities take a position that these are only "Liaison" Offices, India would only add to the fears of the protectionists abroad.

I want to now move to some important areas being addressed by DTC as it also deals with Indian Multinational Corporations.

DTC has brought in a number of issues which will have a material bearing on how Indian multinationals operate. Concept of "Controlled Foreign Corporation" has been introduced in DTC. Sales and services income from transactions with associated enterprises will be automatically considered passive income notwithstanding the fact that the CFC may have generated little less than 50% of such income from active business operations. For example, if TCS has a subsidiary which earns 51% of its revenues out of dividend from its subsidiaries and 49% from IT services it provides in the local country, all the income of such subsidiary will be included in the income of TCS Ltd India for purpose of tax. In case CFC provisions are incorporated, it will have an unintended hardship to Indian MNC, A country like UK gives the "white list" of countries not considered to be tax havens and CFC rules do not apply to the entity operating in these countries

Another new concept introduced in DTC is that of determination of Residency of a company on the basis of "Place of Effective Management (PEM)". PEM is defined as the place where the Board of Directors makes their decision or where they routinely approve the commerciall strategic decisions made by the officers of the company. Indian MNCs will have to evaluate existing corporate structure in order to ensure that the profits of these companies are not taxed here.

In DTC (refer Fourth Schedule), we have another difficult situation on withholding tax. All payments from overseas branches for business carried out in respective countries would attract TDS in India. This must not have been intended. Chargeability of tax in India should be made a prerequisite condition for applicability of WHT (Withholding Tax) provisions.

DTC is silent on the issue of carry forward of MAT credit upto 31st March, 2012, i.e. prior to the date of DTC. This has very big impact on all units operating from Special Economic Zone (SEZ). This seems to be a case of omission and needs correction.

I have dealt with key issues facing IT companies operating globally. I want to move over to an issue of continuity in tax matters. In my company, growth depends on addition of people and creation of suitable infrastructure. We will be recruiting 60,000 people this year. Therefore, the principle we follow is to go to where the people are and not have people come to where we are. Until now, we have expanded through newer office complexes in a city as and when the need arise. We have 19 offices in Mumbai. This kind of proliferation of offices and catering to demand for office space as and when needed was appropriate when profits from Software Technology Park were allowed as deduction under 10A. With the SEZ scheme coming into force, we decided to create large campuses from 2006 and also start moving outside of the large cities. The investments that we intend to make in the next 3 years on campus construction activities in places like Nagpur, Bhubaneshwar and Kochi will exceed ₹ 8000 Crores. This is a significant investment by us and the decisions were made based on tax deduction available under Section 10 AA. While the major users of the SEZ were going to be IT companies, the government formulated the rules in such a way that, unless we started each of these SEZ Units as separate companies, we would not get the total profit from export operation exempted from tax. It took considerable lobbying to get the law reflect the intent. I do not know if the victory in this respect is only a paper victory, because of the implication of the changing Minimum Alternate Tax (MAT) provisions. When MAT of 10% was introduced in 2007, with a 7 year set off, it did not seem to matter to us as, although we were paying very little taxes in India, with the sunset clause in Section 10A, we would adjust the amount within the time frame. Also the original provisions for MAT excluded from its ambit the profits from SEZ. MAT has gone upto 20% and SEZ profits have been brought under MAT net, making it harder to adjust the MAT credit, which is against the letter and spirit of the SEZ Act. The point that has been made from the pre-liberalization days and notably by Mr. Palkhivala that these kinds of tinkering with a declared approach is wrong. More importantly, it negates the basis on which we have made these huge investment decisions.

I want to draw your attention to recent news items on the reopening of the issue relating to taxability of profit on onsite work. This is a matter which has received attention from the late 90s and through circulars and amendments through Finance Bill, the law appeared to be well settled in this case. The tax department needs to get away from continuous reexamination of issues in order to identify nuances which make a tax concession inapplicable.

I have been talking mainly on the Direct Tax issues. I am in an industry which does not have to bear the burden of substantial indirect taxes, as my raw material are people and the output of my organization is largely consumed outside of India.

Presently administration of Value Added Tax (VAT) and Service tax has been posing multiple problems. For example, some States are levying VAT on goods as well as IT services on the ground that IT services are also 'goods'. Another example is that import of Software Products is attracting Custom Duty, VAT as well as Service Tax. It is difficult to understand how the same Software is 'goods' under VAT, 'Service' for purpose of Service Tax and 'Royalty' for purpose of Income Tax, Karnataka High Court had earlier decided that Telecom services provided through optic fiber as 'sale of light energy' and therefore would attract VAT! Fortunately, this decision has been recently reversed by the same High Court - meanwhile the telecom companies had to pay large amounts arising out of the earlier decision.

We believe that Goods and Service Tax (GST) is an important indirect tax reform after independence and it would eliminate cascading of tax resulting in reduction of costs.

The First Discussion Paper (FDP) on the new framework of GST was brought out by the empowered committee of State Finance Ministers in November, 2009. Around the same time, the Task Force constituted by 13th Finance Commission brought out a Report (TFR) in December, 2009 and proposed a model GST framework. There are substantial differences between the two frameworks proposed. The Department of Revenue, Govt of India issued commentary on the FDP. There remains huge confusion as to who would take it forward – there also remains lack of consensus between the States and the Central Government. We hope that the empowered committee of State Finance Ministers under the leadership of Mr Sushil Kumar Modi would take the GST forward and reach a meeting point in discussions with the Centre. In the mean time, in order to take care of the amendments required in the Constitution for adoption of the GST Bill, the Constitution Amendment (115th amendment) Bill, 2011 has been referred by Lok Sabha to its Standing Committee on Finance headed by Mr, Yashwant Sinha. The Bill is pending with the committee and may come for discussion in the winter session of Parliament, When adopted, this Bill would pave the way for the new GST regime. What is urgently required is political and administrative consensus.

We are in a period where regulatory systems are getting special attention from the government. As a CFO, I need to worry about implementation of International Financial Reporting Standards (IFRS) and complying with the new Competition Act, Companies Bill and SEBI Takeover Code. These regulations need to be introduced in a synchronized fashion. Not only are they not done in a synchronized manner, but even the thinking of various arms of the 'government appears to be divergent. Let us take the case of IFRS and tax department. As we attract investments from abroad, it is necessary that our accounts are cast in a manner accepted internationally. In my company, where a large number of overseas funds invest in our shares, our

practice was to report both in US GAAP (Generally Accepted Accounting Principles) and Indian GAAP. It is difficult to keep two different sets of accounts and different figures will lead to varying interpretation of our performance. We heaved a sigh of relief when India was to move to IFRS. Carve outs proposed in Ind AS would come in the way and it is certain that we need to report in IFRS as well as Ind AS, This is not the end of the story. The tax department has already announced that it would not take cognizance of Ind AS. The perception of the tax department is that under the Ind AS, the taxable profit would be lower than that under Indian GAAP. In our case we have seen, this is not true – moreover, given a span of time, there cannot be any impact, If the present position continues, we need to report financials in IFRS for the international community, Ind AS for Indian Companies Act and SEBI and Indian GAAP for purpose of tax. Are we going forward or backward? If as a nation, we want to move to an international standard, all arms of the government need to be in sync.

I have explained the Direct and Indirect Tax issues which are of current and future concern to the IT industry. This is truly an industry which has been created and nurtured by highly educated professionals. If we are seen as a force in the IT field globally, credit must go to the foundation of Knowledge and Learning which India built up over many centuries. Mr. F. C. Kohli, who is recognized as the father of IT in India and under whom I worked for many years, spoke of his vision in 1976 in these immortal words "I want to say that many years ago, there was an industrial revolution. We missed it for reasons beyond our control. Today, there is a new revolution - a revolution in Information Technology which requires neither mechanical bias nor mechanical temperament. Primarily, it requires the capability to think clearly. This we have in abundance. We have an opportunity to participate in this revolution on an equal basis – we have the opportunity, even, to assume leadership in this revolution. If we miss this opportunity, those who follow us will not forgive us for our tardiness and negligence."

There are prophetic words and this industry has lived up to this vision. IT industry comprises of over 5000 organizations, including 9 companies each of which has annual revenue of over one billion US dollars. These 5000 companies use 200 million sq. ft. of office space in India. You would agree with me that this industry has been of great benefit to India in multiple ways, such as in its economic impact, employment of talented persons and attracting foreign companies, as well as foreign investments. Our IT capabilities are beginning to be used for applications in India. UID or Unique Identity for every Indian is a very ambitious programme and will transform India, The benefit will be seen in the applications using this number, If a concept can make inclusive growth a reality, it is this programme, This programme will enable even a migrant worker to meet the Know Your Customer (KYC) norm and thereby open a bank account, This will make the process of managing subsidy or benefit distribution more robust and remove corruption from the system. Proliferation of IT in no longer restricted to cities. Through mobiles and handheld small devices, computer technology is proving to be useful in providing banking ,micro credit, payment and other services to remote parts.

I am drawing your attention to all these to show how important this industry is for the transformation of India. In order for the benefit to be shared by all persons, we need to have affordable computing devices and this will require innovation. What will determine our continued success in

this field will be based on the enabling environment that we can create in India.

The enabling environment will be to make this industry attractive in order to get entrepreneurs to try new things. I have talked about IT industry because that is the industry I am familiar with. There are many knowledge oriented industries where India is beginning to emerge as a major force. Frugal Engineering is one such area and many auto makers are focusing on India to design low cost vehicles. It is in this context that both Direct and Indirect Tax system have to be supportive. For us to have progress and social equity, economic activities need to expand and that by itself will bring additional revenues to the government and IT will help the government in more efficient and transparent management of resources.

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(24-12-1949 – 19-10-1988)

Late Mr. Shailesh Kapadia, FCA, was a Chartered Accountant by profession and was a partner of M/s G.M. Kapadia & Co. and M/s Kapadia Associates, Chartered Accountants, Mumbai.

Shailesh qualified as a Chartered Accountant in 1974 after completing his Articles with M/s Dalal & Shah and M/s G.M. Kapadia & Co., Chartered Accountants, Mumbai. Shailesh had done his schooling at Scindia School, Gwalior and he graduated in Commerce from the Sydenham College of Commerce & Economics, Mumbai in 1970.

Shailesh enjoyed the confidence of clients, colleagues and friends. He had a charming personality and was able to achieve almost every task allotted to him. In his short but dynamic professional career, spanning over fourteen years, Shailesh held important positions in various professional and public institutions. His leadership qualities came to the fore when he was the President of the Bombay Chartered Accountants' Society in the year 1982-83. During his tenure he successfully organized the Third Regional Conference at Mumbai. He was member, Institute of Fiscal Studies, U.K.; member of the Law Committee and Vice-chairman of the Direct Taxation Committee, Indian Merchants' Chamber, He was also a Director of several public companies in India and Trustee of various Public Charitable Trusts.

He regularly contributed papers on diverse subjects of professional interest at refresher courses, seminars and conferences organised by professional bodies,

"People must come to accept private enterprise not as a necessary evil, but as an affirmative good".

– **Eugene Black**
Former President,
World Bank

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In recent years the Forum has also been focusing on the youth with a view to developing good and well-informed citizenship. A number of youth activities including essay and elocution contests and leadership training camps etc., are organised every year towards this goal.

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