

Tax Hotline

October 09, 2002

REORGANIZATION BENEFITS FOR COMPANIES HAVING UNITS IN A SEZ, ETC.

The Government of India in its explanatory notes to the Finance Act 2002, has clarified that where a body corporate, having a unit/undertaking in the Software Technology Park ("STP"), Special Economic Zone ("SEZ"), etc., reorganizes the benefit available to the unit under section 10A of the Indian Income Tax Act, 1961 ("ITA") shall continue to be available if certain conditions are met. This amendment is effective from financial year April 1, 2002. This clarification by the Government has thrown open new planning opportunities for the companies wishing to restructure their business without potential loss of tax holiday.

Under the ITA, profits derived by a unit set up in a SEZ/STP, etc. from export of computer software are exempt from income tax. This exemption is available for a maximum period of 10 years till the financial year ending March 31, 2009. However, if in any year, the beneficial interest in or ownership of an unit changes or the shareholding of a company changes by more than 49%, the tax holiday available under Section 10A would have been lost. This provision proved to be a stumbling block for many a genuine reorganizations.

According to the provisions of the aforesaid section, if the business of a partnership or a sole proprietary concern is reorganized into a company, then such benefit will continue to be available to the company if the beneficial ownership to the extent of 51% of the new entity continues to be with the original promoters and such shareholding continues for the period the tax holiday is to be claimed. The Government has now clarified that such a benefit will continue to be available to a company, which transfers ownership of the STP/SEZ, etc. unit to a company in which it has 51% shareholding, as in that case the parent company would be considered as the proprietor of such unit. Prima facie it seems to address the scenarios whereby the units would be hived off into a subsidiary but it remains to be seen if the same interpretation can be applied to amalgamations and demergers/spin-offs also.

With the increasing global interest in the Indian companies engaged in BPO and software development space, this clarification would provide the much needed respite to companies lined up for M&A activities and to the private equity investors who are eyeing such opportunities.

Source: Circular No. 8/2002 – Explanatory Notes on the provisions relating to direct taxes

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