

# Booz & Company: Beyond Arbitrage: Offshoring of Engineering, Research and Development

Engineering represents a large opportunity for India, which is at the cusp of becoming a major ERD (Engineering, Research & Development) center for the globe. Contrary to the often held belief that India is the center for low-end and mundane work, Indian engineers are key cogs in the engineering wheels of technology leaders ranging from Cisco to Microsoft.

The market for offshoring of ERD in India is rapidly expanding and is likely to hit US\$ 35-40 billion by 2020. Unlike IT, a significant share of the growth in ERD offshoring is being driven by the captive centers of the global companies and relatively smaller-focused engineering vendors.

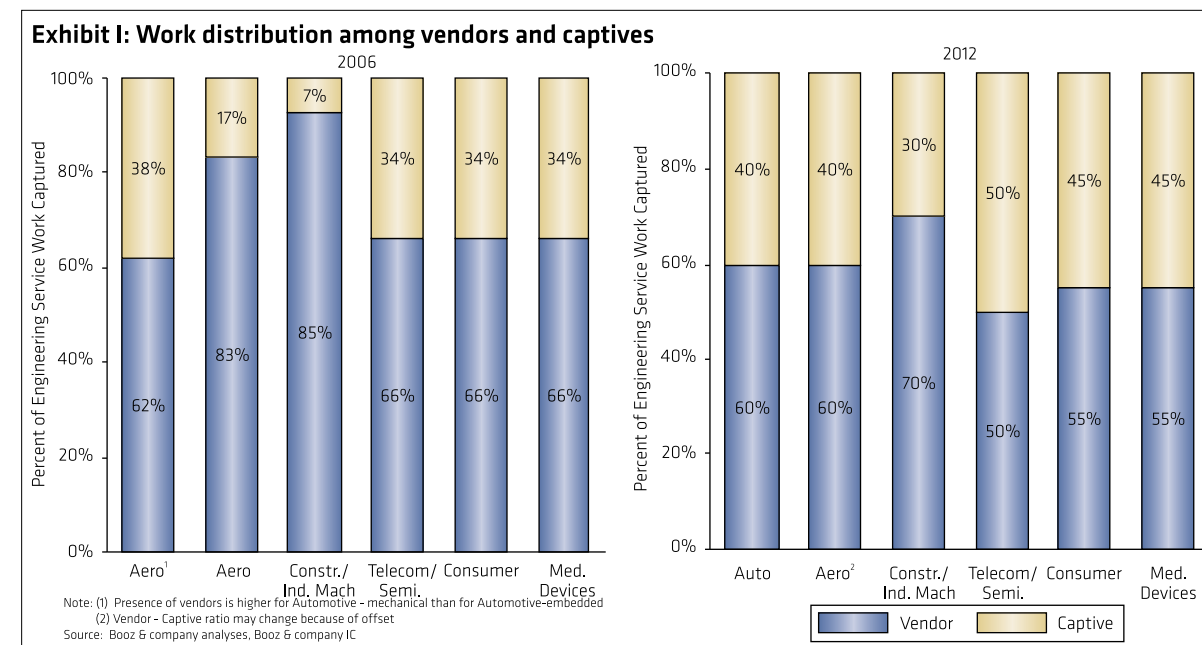
The growth in ERD offshoring is not just a result of global companies seeking a low cost source, as is the case for IT, or more recently, business processes. Organizations are looking at India to optimize the equation hinged on the 3Cs (Cost-Capability-Capacity). A combination of a low cost base, talent pool and capacity is helping India build a position in the global technical network of the major corporations and become part of the global ERD value chain.

Cost, once the primary factor, is becoming secondary and often, for sectors such as Telecom-hi-tech, a tertiary factor. For instance, sectors such as automotive and industrials are looking at India as

a location for technical resources and to accelerate product and technology development. Companies, especially the ones in longer cycle time industries such as aerospace and automotive are struggling to find technical capacity and capability to shift their product-technology portfolios at the same pace as customers are shifting their taste. India is among the few potential locations that offer a solution.

A Pune-based vendor, for instance, with less than US\$ 20 million in engineering revenue, is driving an effort of US\$ 50 billion company to build environmental friendly technology.

Going forward, those intending to play in either demand or the supply side of the market, as providers or consumers of ERD services need to modulate their business models and strategies to resonate with the markets. Cost arbitrage based models, often dominant for functions such as call centers or IT, don't work for ERD. ERD demands an approach that accounts for longer time horizons for skills development, higher investments in hardware, software and liveware. Vendors operating in, or aspiring to, effectively operate in the space are likely to benefit by demonstrating flexibility for alternate business models, value based pricing structure and shared governance and operating models.



# SEZs: A window for the IT sector

The concept of Special Economic Zones ("SEZs") which are specified delineated duty free territories and deemed to be foreign territories for the purpose of trade is not new to India. The SEZ policy was first introduced in April 2000, as a part of the Export-Import policy of the country. To provide a long-term and stable policy and signal the government's commitment to increase economic activity in the country, a comprehensive SEZ legislation, the Special Economic Zone Act, 2005 ('SEZ Act') was passed in June 2005.

Under the umbrella of the SEZs, software services companies can provide information-enabled services such as back-office operations, call centers, content development or animation, data processing, engineering and design, graphic information system services, human resources services, insurance claim processing, legal data bases, medical transcription, payroll, remote maintenance, revenue accounting, support centers and web-site services.

## Information Technology SEZ ("IT SEZ")

In recognition of the potential of the IT sector to transform the Indian economy, and to provide the requisite impetus special concessions have been afforded under the SEZ policy for this sector.

## Plugging the loopholes

While the new SEZ Act has definitely won the hearts of many in the IT industry, there are certain shortcomings/grey areas in the legislation that need to be addressed.

One of the key gaps in the new SEZ legislation is that while the existing section 10A of the Act provides for computing the deduction on the basis of the total turnover of the unit, the newly introduced section 10AA of the Act provides for computing the deduction on the basis of total turnover of the business of the assessee. In this regard, clarification from the Government is required on what constitutes "business of the assessee," since in its current form a lower deduction/ exemption is available to SEZ units, based on the formula provided.

With a view to promote greenfield investment and catalyze employment generation, the policy makers have finally indicated that conversion/ relocation of existing STP/ EOU/ EHTP units into SEZ units would not be permitted under the SEZ policy. However, the industry is of the opinion that the mere creation of SEZs without extending similar advantages to units registered under the Software Technology Parks of India Scheme would be detrimental to the interests of companies located in the latter.

Tax benefits		
Section 10AA introduced under the Indian Income Tax Act, 1961 ("the Act") to provide for deduction to SEZ units commencing manufacturing or producing articles or things or which started providing services from April 1, 2005 states the following:		
Quantum of deduction	SEZ units set up on or after April 1, 2002 but before March 31, 2005	SEZ units set up on or after April 1, 2005
100% of export profits	First 5 years starting from the year in which manufacture/ provision of services commences	First 5 years starting from the year in which manufacture/ provision of services commences
50% of export profits	Next 2 years	Next 5 years
Upto 50% of export profits transferred to SEZ Reinvestment Reserve Account, subject to conditions	Next 3 years	Next 5 years
The other fiscal incentives contemplated by the SEZ Act are as follows:		
Indirect tax - Developers and units	Direct tax - SEZ developers	Direct tax - SEZ units
Exemption from customs duty	10-year tax holiday to SEZ developers	Phased tax holiday to units operating in SEZs and earning export profits over a period of 15 years
Exemption from excise duty	Exemption from levy of minimum alternate tax at 8.415% (on book profits)	Exemption from levy of minimum alternate tax at 8.415% (on book profits)
Exemption from service tax subject to 'export of services rules'	Exemption from levy of dividend distribution tax at 14.025%	
Exemption from central sales tax		
Drawback of duties paid on goods/services bought from outside the SEZ area	Exemption on income earned by investors from investments made in developer company	

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