KATALYST ADVISORS LLP

Katalyst Kaleidoscope

Special Issue: Taxation Laws (Amendment) Ordinance, 2019

A. Background and Macro Dimensions

Corporate tax rates in India have been in the 35% range for many years now and there has, accordingly, been a clamour for reduction for many years. This has particularly intensified with a reduction of rates in other countries such as in UK and USA. Of course, these are not fully comparable because they are fairly advanced economies, but even at an Asia level, Indian tax rates have been very high.

It is understood that the Direct Tax Code Report has recommended a reduction in corporate tax rates; the report is not yet available in the public domain, but press reports clearly indicate this.

It is against this backdrop that the corporate tax rate cut needs to be viewed and it is clearly one of the significant tax reforms that this country has seen, the last one clearly being GST.

The rate cuts are effective from this fiscal year itself, and the revenue loss is estimated at INR 1,45,000 crs. This needs to be viewed in the light of the fact that the corporate tax revenue as per revised budget estimates was INR 7,66,000 crs as announced in the budget on 5 July 2019. The latter figure is itself very doubtful of being met, given the economic slowdown, but given the reduction from 35% to 25% is almost a 30% drop and therefore, if one takes 30% of INR 7,66,000 crs, the figure is far in excess of INR 1,45,000 crs and hence, there is a possibility that this figure of INR 1,45,000 crs may actually turn out to be significantly more, putting a lot of stress on fiscal deficit; however the Finance Minister has said that there is no move to revise expenditure or fiscal deficit, both of which propositions seem counter intuitive.

B. Key Provisions as prescribed by the Taxation Laws (Amendment) Ordinance, 2019 ("Ordinance")

1. Reduction in Corporate Tax Rates

1.1 The key aspect is that corporate tax rates have been slashed with effect from this fiscal year, but there is an option to choose the reduced corporate tax rates and if one chooses that option, then the company cannot avail the incentives and exemptions. In other words, it is an irreversible choice. If that choice is adopted, there is no MAT either (the rate for other companies opting for lower tax rate is now slashed from 21.55% to 17.47% inclusive of surcharge and cess).

1.2 A table capturing the effective tax rates under various optional tax scenarios is as below:

Parameters	Option #1	Option #2	Option #3	Option #4	Option #5
Base Corporate tax rate	**25%**	**22%**	**15%**	**25%**	**30%**
Section under ITA	**115BA**	**115BAA** (Newly introduced)	**115BAB** (Newly introduced)	**Turnover < INR 400 Cr during FYE2018**	**Turnover > INR 400 Cr during FYE2018**
Eligible legal entity	Domestic Company	Domestic Company	Domestic Company	Domestic Company	Domestic Company

Parameters	Option #1	Option #2	Option #3	Option #4	Option #5
MAT	15%	Not applicable	Not applicable	15%	15%
Eligible Business operations	Engaged in manufacturing business as its sole business.	All businesses are eligible.	Engaged in manufacturing business as its sole business.	All businesses are eligible.	All businesses are eligible.
Key Conditions	• Incorporated on or after 1 March 2016. • No claim under prescribed tax holiday or incentives or additional depreciation. *(Refer point 1.3 below)* • No loss carried forward is allowed to be set-off, if such loss was due to prescribed tax holiday or incentives or additional depreciation • Option once exercised cannot be withdrawn.	• No claim under prescribed tax holiday or incentives or additional depreciation. *(Refer point 1.3 below)* • No loss carried forward is allowed to be set-off, if such loss was due to prescribed tax holiday or incentives or additional depreciation • Option once exercised cannot be withdrawn.	• Incorporated on or after 1 October 2019 and production must commence before 31 March 2023. • Not formed by splitting-up or reconstruction and does not use used machinery > 20% of its total machinery. • AND same conditions as mentioned in Option #2. • Anti-abuse provisions to prevent mis-use of this provision.	• No additional conditions	• No additional conditions
Surcharge	Progressive rate, highest being 12%	Flat 10%	Flat 10%	Progressive rate, highest being 12%	Progressive rate, highest being 12%

1.3 The list of exemptions is given below:

Section	Name
10AA	Special provisions in respect of newly established units in Special Economic Zones

32AD	Investment in new plant or machinery in notified backward areas in certain states
80H to Section 80TT (except section 80JJAA)	Deduction in respect of certain incomes
32(1)(iia)	Depreciation
35(1)(ii), (iia), (iii), (2AA), (2AB)	Expenditure on scientific research
35AD	Deduction in respect of expenditure on specified business
35CCC	Expenditure on agricultural extension project
35CCD	Expenditure on skill development project
33AB	Tea development account, coffee development account and rubber development account
33ABA	Site restoration fund
Note: *It would be important to note that for certain incentives and exemptions, particularly u/s 10AA, the duration of the exemption period would be approaching its end, thereby permitting the entities to adopt a lower tax rate without foregoing any benefit.*	

1.4 The table below gives comparative details of effective tax rates:

Type of Company	Old tax rate (inclusive of surcharge and cess) (%)	New tax rate (inclusive of surcharge and cess) (%)	Additional benefits
Corporates not availing incentives / exemptions offered under the Income Tax Act	34.94	25.17	MAT provisions are not applicable
Corporates availing incentives / exemptions offered under the Income Tax Act	34.94	34.94	MAT rate shall be reduced from effective rate of ~21.5% to 17.5%
New Manufacturing Companies (incorporated after 1 October 2019 and commencing production before 31 March 2023) not availing incentives / exemptions offered under the Income Tax Act	29.12	17.16	MAT provisions are not applicable

2. Some subtle aspects

2.1 Companies will have to make an analysis of what works for them. It is possible that a company may be entitled to certain exemptions and hence the reduced corporate tax rate may not work for them; for example, in case of an SEZ, which may lead to a situation that the actual tax is lower than 25% in which case, it may opt for the lower rate post the exemption period. It is important to note that it is possible to shift to the lower rate at a later point of time also and not necessarily from this financial year.

2.2 In addition to the above, for domestic companies having carried-forward losses, they may need to evaluate whether and what portion of such past losses is attributable to the above incentives and exemptions. If there are significant losses being carried-forward which are attributable to the above incentives and exemptions, then the company may not opt for lower corporate tax rate since one of the conditions u/s 115BAA is that the company which opts for such exemption is not eligible to claim a set off of such attributable losses.

2.3 The choice of legal entity eg: domestic company vs. LLPs/partnership firms, will once again become relevant and this time, it may not be loaded in favour of LLPs. One needs to evaluate carefully the impact because of reduced tax rate for domestic companies; however, the extraction costs, either in the form of dividends or buy back, from a company, may still skew the balance in favour of the LLPs. Hence, a careful analysis for either migration to a company from an LLP or setting up a new business in the form of an LLP would be warranted.

2.4 As mentioned above, the choice of opting to the lower rate is irreversible and therefore, the choice needs to be made carefully considering all aspects.

2.5 The doing away with MAT for companies opting for the lower rate will be very useful, not only for operating companies, but also for holding companies or investment companies which may derive capital gains on sale of investment which may not be taxable otherwise (either due to the 31 January 2018 grandfathering or for any other reason), but would have still paid MAT. It is also important to note that, even if companies opt for lower corporate tax rates u/s 115BAA and 115BAB of the Act which are still higher than the tax on long term capital gains arising on sale of listed equity shares, such long-term capital gains should continue to be chargeable under special rate of 11.54% u/s 112A, since section 115BAA and section 115BAB are subject to the provisions of the Chapter XII, which, incidentally, includes section 112A.

2.6 The Ordinance, vide insertion of subsection 5A to section 115JB, has provided that the provisions of MAT u/s 115JB shall not be applicable to a company which has exercised the option to opt for lower rate of tax u/s 115BAA. Therefore, the question that arises is whether the companies exercising the option under section 115BAA of the Act for eligibility of lower rate of corporate tax, can set off the MAT credit u/s 115JAA against the tax liability arising under the normal provisions of the Act (i.e. u/s 115BAA of the Act). Some scenarios could be as under:

- MAT credit against entire tax on total income is set off which would result in accelerated set off of MAT credit in the initial years, leading to ~25% tax on total income in the later years; or
- MAT credit is set-off in a tempered manner i.e. set off MAT credit against tax on total income (i.e. 25%) so as to restrict the amount of tax to ~17% (i.e. rate of tax on MAT); or
- Prior to a company opting for a lower capital gains tax rate u/s 115BAA, MAT credit is first set off against the tax on total income (i.e. at the rate of ~35%) and thereafter, the domestic company migrates to lower corporate tax rate u/s 115BAA;

The Revenue Authorities may deny set off of MAT credit in either of the above scenarios, given the fact that the corporate tax rates have effectively been slashed significantly and that no further incentive or exemption should, therefore, be available.

2.7 In relation to manufacturing activities, there is an even lower rate subject to a new company being formed on or after 1 October 2019 and commencing production on or before 31 March 2023. Some key aspects therein:

- The language of section 115BAB of the Act provides for setting up of a new company to undertake manufacturing activity, which is surprising; the incentive should logically have been to new manufacturing units (even though a part of the same company) as has been in the case of several incentives in the Income Tax Act till date, (such as section 80IB.)

- This will lead to needless proliferation of companies; for example, in case of a listed company, it cannot set up a manufacturing unit within the same entity and therefore, may do so in the form of a 100% subsidiary. This will need to needless proliferation of companies. It may have been a better idea to look at two differential rates for the same company, recognising that there could be certain tax and allocation issues, which anyway are existent in the current regime.

- Manufacturing at a meaningful level takes a significant amount of time, but plans especially in terms of commercial feasibility such as demand analysis, corporate approvals, land acquisition, plant design and various other related dimensions take time. In this context, given that 31 March 2023 is just 3.5 years away, the time period is somewhat short and one must also consider the possibility that if the manufacturing entity is set up with one of the aspects as this lower tax rate in mind, but actually the plant does not go on stream by then, it could throw fiscal calculations out of gear.

3. Impact on corporate profits

3.1 The impact on corporate profits on an as-is where-is basis is obviously significant. Assuming a profit of INR 100, the earlier 35% tax rate leaves INR 65 as Profit After Tax ('PAT'). This PAT will now become INR 75 if one opts for the lower rate and therefore, the rise in corporate profits will be from INR 65 to INR 75, which is approximately 10% of the profits before taxes ('PBT').

3.2 From a macro perspective, a number of corporations would utilize these savings in tax for deleveraging which will strengthen their ability to invest gradually.

3.3 In relation to some of the Nifty 50 companies, here is a snapshot of some companies with an effective rate above 30%.

Sr. No.	Companies	Tax Rates (%)	
		Effective Tax Rate(old)	Effective Tax Rate(new)
1.	Bajaj Auto	31.00	25.17
2.	Eicher Motors	34.70	25.17
3.	HDFC Bank	34.00	25.17
4.	Siemens	34.60	25.17
5.	Asian Paints	34.00	25.17
6.	Grasim Industries	33.10	25.17
7.	Hindustan Unilever	31.50	25.60
8.	Ultratech Cement	31.30	25.17
9.	TCS (since ETR of TCS is 23.7%, it may not opt for the new regime)	23.70	23.70
10.	ICICI Bank	28.50	25.17

3.4 In terms of sectors, corporates having lower capex or incentives and therefore, high tax rates and likely to benefit more. Banks, FMCGs and diversified financial companies are some likely beneficiaries, though some of them may pass on part of the benefit to consumers in the form of lower prices which also will have the impact of boosting demand.

4. Comparison with other Asian Economies:

4.1 After the reduction the rate has become significantly comparable to rates in other Asian countries.

4.2 The table below will be very revealing

4.3 It would be seen that every economy has cut down corporate tax rates so as to bring them in the 20%-25% tax bracket (India being an outlier @35%).

5. Impact on valuation and IPOs

5.1 Simply on a status-quo basis, with higher profits at a PAT level, a simple price earning calculation itself will lead to higher valuations, and the recent rise in the stock price of listed companies has clearly borne this out.

5.2 This is also likely to boost IPO offerings, and to some extent, give a boost to the deal cycle, at least from a seller perspective, though it could be a dampener from a buyer perspective, to some extent.

6. Impact on Deal Scenarios/Restructuring:

6.1 Domestic companies intending to re-structure their operations to avail the 17% rate of corporate tax for new manufacturing companies will need to keep the following in mind:

- Restrictions on splitting up/reconstruction of existing businesses (as already captured in para 1.2 above).

- General anti-avoidance provisions

6.2 It would be important to note that the reduced corporate tax rates would have also have a (relatively) beneficial impact on the incomes such as interest income, short term capital gains tax (other than section 111A of the Act), incomes falling under the preview of Section 56(2)(x) and other incomes falling under the head "Income from Other Sources", since the effective tax rate on such incomes would also be reduced to ~25%

6.3 The Finance (No. 2) Act, 2019 introduced the infamous surcharge of upto 37% in the hands of all taxpayers including FPIs, but excluding Companies and Firms (including LLPs), on all incomes above INR 5 crs (including long-term/ short-term capital gains) arising from sale of equity shares, units of business trusts or equity-oriented mutual funds. Consequentially and for instance, the income from sale of long-term equity shares, climbed up from effective tax rate of 11.96% (all inclusive) to the highest rate of 14.25%. This proved to be a serious dis-incentive for investment and capital markets reacted adversely to this.

With the announcements on 20 September 2019, the FM has restored the effective tax rate of 11.96% on income arising from sale of long-term equity/ units or equity oriented mutual funds. This reduced rate however, is made applicable only to individuals, HUFs and AOPs/BoIs including FPIs. It would be important to note that the effective tax rate in case of companies and LLPs continues to remain at 11.65%

The increased surcharge of 37%, has been continued on all other incomes in the hands of all taxpayers. For instance, individuals earning income above INR 5 crs, will pay tax at the highest rate of 42.7%, if such income is from sources other than capital gains.

C. Indirect Tax Provisions:

On the same day as the announcement of the Ordinance, the GST council, it its 37th meeting, *inter-alia*, approved various proposals relating to deferment of new return system, withdrawal of a recently issued circular on post-sales discount, reduction of GST rates on various goods and services, increase in rate of certain items, change in place of supply of certain activities, etc.

Amongst the various proposals approved by the council, the updates relating to 'key GST rate change' in various sectors are mentioned below:

Sr no.	Particulars	From (%)	To (%)
A	**Decrease in rates**		
1	Hotels charging room tariff between		
	• INR 1,001 – INR 7,500	18	12
	• Above INR 7,500	28	18
2	Outdoor catering	18	5 (Without ITC)
3	Job work services for diamond industry	5	1.5
4	Job work services for engineering industry	18	12
5	Parts of Solid Fasteners	18	12
6	Marine fuel	18	5
7	Wet Grinders (consisting stone as a grinder)	12	5

8	Cut and polished semi-precious stones	3	0.25
9	Specified goods for petroleum operation under Hydrocarbon Exploration Licensing Policy	12-18	5
10	Vehicles below 4000m in length carrying up to 13 people having engine capacity of • 1500 CC – diesel • 1200 CC- petrol	15(cess) 15(cess)	3(cess) 1(cess)
B	**Increase in rates**		
1	Railway wagon, coaches	5	12
2	Caffeinated beverages	18	28+12(Cess)
C	**Exemptions in rates**		
1	Import of specified defence goods (up to 2024)	Applicable rate	NIL
2	Import of silver/platinum by specified agencies and its supply to exporters for export of jewellery	Applicable rate	NIL

Note: It is proposed to issue notifications giving effect of the above changes on 1 October, 2019.

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