Analysis of new reduced corporate tax rates

CTC Pune Study Group Meeting
11 January 2020

Pramod Achuthan

Background – A legislative backdrop of The Amendment Act

- The Taxation Laws (Amendment) Ordinance, 2019 (hereafter referred as Ordinance) providing for a major reduction in corporate tax rates, was promulgated on 20 September 2019
- Ordinance promulgated by the President, effective immediately
- To repeal and replace the Ordinance, The Taxation Laws (Amendment) Bill, 2019 (hereafter referred as The Amendment Bill) was introduced in Lok Sabha on 25 November 2019
- The Amendment Bill, is largely in line with the Ordinance promulgated by the President. However, in view of representations received from various stakeholders to provide certainty on issues emerging from the Ordinance, the Amendment Bill has made further amendments.
- The Amendment Bill, was approved by both house of the Parliament and received assent of President of India on 11 December 2019 and thus formed as an Act - The Taxation Laws (Amendment) Act, 2019 (hereafter referred as The Amendment Act) to amend the Income-tax Act, 1961 and the Finance (No. 2) Act 2019

Tax rate cuts – A panacea for all evils plaguing the Indian economy?

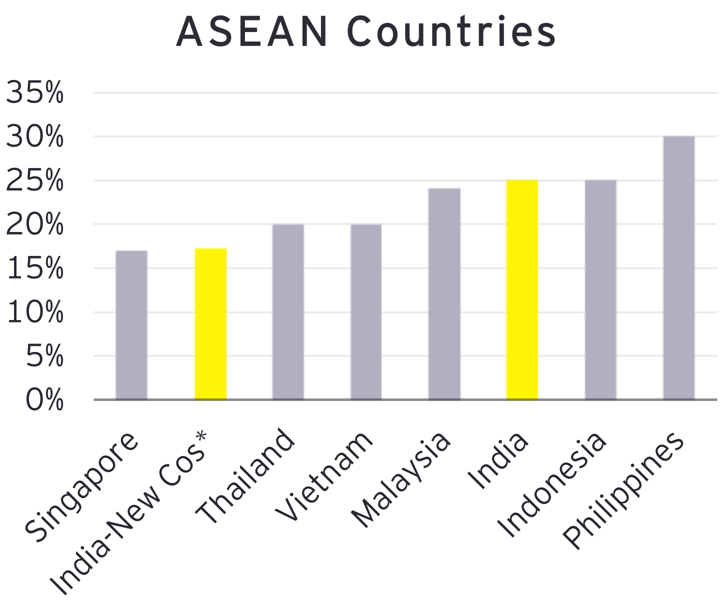
Excerpts from the Press Note dated 20 September 2019

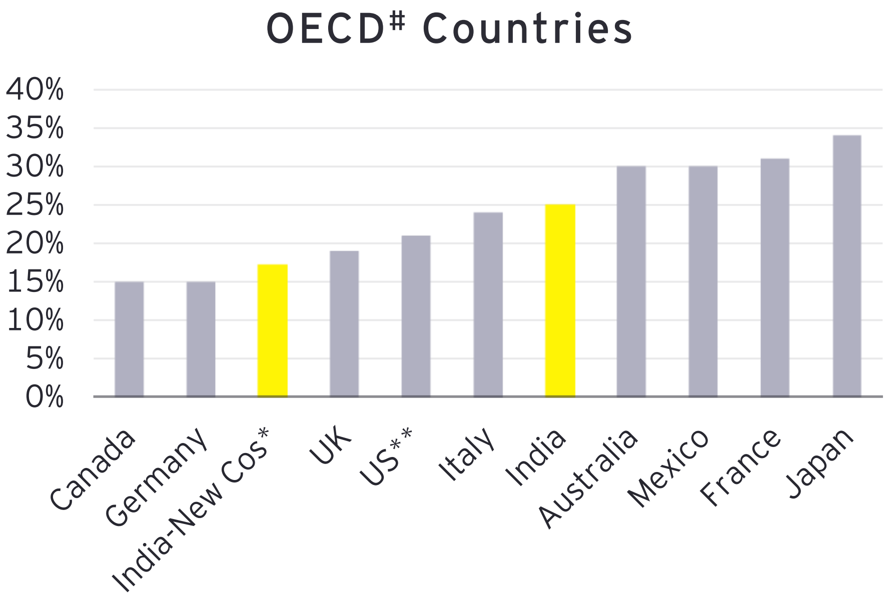
In order to attract fresh investment in manufacturing and thereby provide boost to 'Make-in-India' initiative of the Government*, another new provision has been inserted in the Income-tax Act with effect from FY 2019-20 which* ***allows any new domestic company incorporated on or after 1st October 2019 making fresh investment in manufacturing, an option to pay income-tax at the rate of 15%****……*

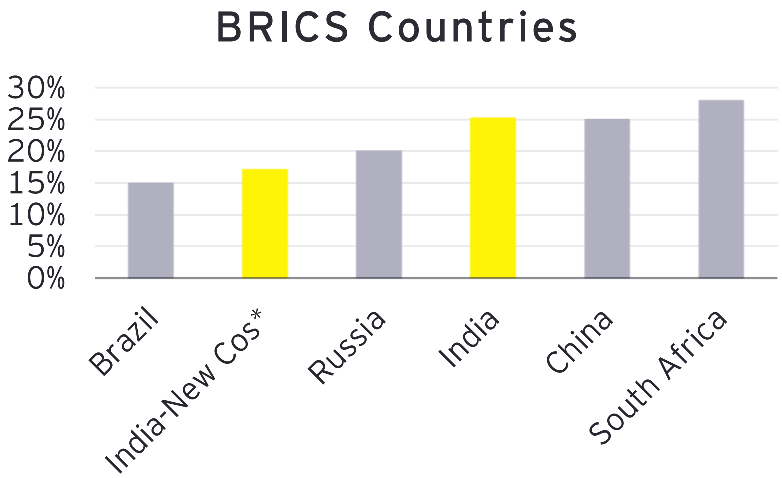
In ***order to promote growth and investment****, a new provision has been inserted in the Income-tax Act with effect from FY 2019-20* ***which allows any domestic company an option to pay income-tax at the rate of 22%*** *subject to condition that they will not avail any exemption/incentive……*

Total revenue foregone for the reduction in corporate tax rate and other relief estimated at Rs. 1,45,000 crore.

India improves its tax competitiveness







*For new manufacturing companies set-up on/ after 1 Oct 2019 and commenced manufacturing on /before 31 Mar 2023

** Only central taxes

OECD average statutory tax rate for 2018 was 21.4%

Existing Corporate Tax Rates[1]

Particulars	Large Domestic Cos.	Small Domestic Cos.*	S. 115BA –New Domestic Cos. (set up on or after 1 March 2016)	Foreign Cos.
Base Tax Rate	30%	25%	25%	40%
Maximum Effective Tax Rate	34.94%	29.12%	29.12%	43.68%
Availability of Exemptions/Incentives	Yes	Yes	No	Yes
Maximum Effective Minimum Alternate Tax (MAT) u/s 115JB rate	21.55%	21.55%	21.55%	20.20%#
Depreciation Benefit	Yes	Yes	Yes – except additional depreciation	Yes
Set off and carry forward of losses	Yes	Yes	Yes, except losses pertaining to exemptions, incentives and additional depreciation	Yes

[1] Income-tax Act, 1961 (ITA) read with the Finance (No 2) Act, 2019

** Where turnover in FY 2017-18 does not exceed INR 400 crores (~USD57m)*

\# *In certain cases, foreign company is exempt from levy of MAT.*

Concessional tax rates (CTR) – Brought in by The Amendment Act
A Comparison

Particulars	The Amendment Act		Existing		
	S. 115BAB (15% CTR)	S. 115BAA (22% CTR)	S. 115BA	Normal Tax Rate	LLP
Base Tax Rate	15%	22%	25%	30%	30%
Maximum Effective Tax Rate	17.16%	25.17%	29.12%	34.94%	34.94%
Income	100.00	100.00	100.00	100.00	100.00
Less: Corporate Tax	17.16	25.17	29.12	34.94	34.94
Profit after tax	82.84	74.83	70.88	65.06	65.06
Less: Dividend Distribution tax @ 20.56%	14.13	12.76	12.09	11.10	NA
Net amount available to owners	68.71	62.07	58.79	53.96	65.06
Total Tax Outflow	31.29	37.93	41.21	46.04	34.94

1. No MAT on S. 115BAA/115BAB companies.
2. MAT rate for other companies reduced to 15% (plus surcharge and cess)
3. Tax outflow above is without considering super rich levy on dividend u/s. 115BBDA
4. If DDT rate is restricted by the Tax Treaty, tax outflow above will vary

Concessional tax rate (CTR)
Key conditions applicable

Parameters	22% CTR	15% CTR
Effective Tax Rate (ETR)	25.17%	17.16%
Year of Applicability	AY 2020-21 and onwards	AY 2020-21 and onwards
Existing or new domestic companies	Applicable to all, existing as well as new domestic companies	New domestic manufacturing companies set up and registered on or after 1 October 2019 and commencing manufacture by 31 March 2023
Nature of Industry	No restriction (covers everyone including service/ trading industry/finance entities)	Companies engaged solely in manufacture or production of any article or thing and related research or distribution
Exercise of Option	On or before due date of filing the return for any year. Option once exercised cannot be withdrawn	On or before due date of filing the return for filing the 1st year return. Option once exercised cannot be withdrawn
Any formative conditions applicable	None	• Yes; not be formed by split-up/reconstruction of existing business • Not to use second hand plant and machinery (Subject to 80:20 condition)
Specific Domestic Transaction Provisions	Not Applicable	Applicable

Concessional tax rate (CTR)
Conditions applicable

Parameters	Details
Denial of Deduction/ Incentives	Reduced rate can be claimed subject to the condition that certain specified deduction/incentives such as deduction under section 10AA, weighted deduction under section 35(2AB) etc are not available. Additionally, the carried forward losses attributable to such specified deductions will not be available for set-off. *Refer next slide for further details*
Consequences of default	▸ Company failing to satisfy the conditions prescribed above, shall be ineligible for the option of beneficial rates in the year of default and subsequent years* ▸ Additionally, manufacturing companies opting for 15% CTR, will have the option to opt for 22% CTR in the year of default and subsequent years
MAT	Not Applicable. MAT credit with respect to taxes paid under MAT in past years will be lost once the option is exercised.
Sunset Date	No Sunset Date for reduced rates. However, the option u/s 115BAB cannot be exercised for companies which set-up or commence operations after 31 March 2023

- For Companies falling under section 115BAA, the reduced tax rate of 25.17% applies to all sources of income (except when special tax rates apply. Eg Tax rate on capital gains will continue to be as per S. 111A & S. 112/ 112A)
- No turnover related threshold conditions

***Conditions to satisfy for 22% CTR?**

Concessional tax rate (CTR)
Conditions applicable – Non-availability of deduction/incentives

Section	Type of deduction/incentive
10AA	Deduction on export profits to SEZ
32(1)(iia)	Additional depreciation
32AD	Allowance for investment in P&M in notified backward areas
33AB	Deduction for Tea, coffee or rubber business
33ABA	Site restoration fund
Clause (ii), (iia) & (iii) to 35(1)	Deduction of sum paid to research association / university/college/company for use in scientific research or research association for research in social science
35(2A) & 35(2AB)	Weighted deduction for • Payments to specified institutions & • Expenditure in in-house R&D facility
35AD	Deduction of expenses on specified business
35CCC	Expenditure on agriculture extension project
35CCD	Expenditure on skill development project
Section 80-IA, 80-IB	All specified deductions covered under Heading "C" of Chapter VI-A except 80JJAA

Carried forward losses attributable to these deductions will not be available for set-off

Unabsorbed depreciation attributable to additional depreciation to be adjusted with opening WDV as on 1 April 2019 in the prescribed manner

Interpretation or implementation issues

- Breakeven of deduction/incentives to decide when to opt for lower CTR
- Eligibility of 22% CTR in case of taxpayer not claiming any such deductions although eligible for it
- Computation of loss attributable to these deductions especially in cases where total loss includes loss from normal operations as well

15% CTR – Some key issues

15% CTR – Some key issues

- 15% CTR applicable only to income from eligible business and not to company as a whole
- Table depicting snapshot view of different tax rates applicable to companies eligible for 15% CTR:

Nature of income	Tax rate
Income which is neither incidental to nor derived from manufacturing or production of an article or thing and in respect of which no specific rate of tax is provided	22% on gross basis
Short term capital gains on sale of non-depreciable asset	22%
Profits derived in excess of ALP from transactions with parties having close connection with the taxpayer	30%
Income other than the above from the eligible business	15%

- What all qualifies as *"Income which is neither incidental to nor derived from manufacturing.."* ?
  - Interest income on electricity deposit or rent deposit?
  - Interest on fixed deposit kept as margin money for LC or other facility?
  - Interest income from investment of surplus funds?
  - Rental income from temporary letting of surplus assets like premises or machineries?
- Tax rate on income from distribution activity of goods manufactured?

15% CTR – Some key issues

- Nature of Eligible business activities
  a) Manufacture or production of article or thing
     - Scope of manufacture – Activities like software development, mining, printing of books or production of cinematograph film, conversion of marble blocks or similar items into slabs, specifically excluded.
     - What about power generation, contract manufacture?
  b) Research in relation to such articles
  c) Distribution of such article or thing (could be physical/digital; wholesale/retail)

- Any activity other than above could disqualify a company from 15% CTR
  - Limitation could apply to activity of buying and selling of goods, even if associated with manufacturing activity?
  - Participation in a partnership or LLP may be indicative of being engaged in business?

15% CTR – Some key issues

- Business is not formed by splitting or reconstruction of business already in existence
  - Applicable to company; or its business?
- **Splitting up of existing business:**
  - Existing business is broken up and different activities previously conducted are carried on independently
  - New company formed is an integral part of earlier existing business and it is only a question of breaking up of the same/ earlier business
- **Reconstruction of existing business:**
  - Substantially same business is carried out by substantially the same persons
  - Rejuvenation or rehabilitation of an existing business – the underlying idea is continuation of business but in some altered/ varied form
- Condition to be satisfied only in year of formation?

15% CTR – Some key issues

- Restriction on use of second hand plant and machineries - Perceived as the most controversial restriction
  - Conventionally, restriction applied to eligible undertaking not **"formed"** by transfer of second hand plant and machinery (typically 80:20 condition)
  - 15% CTR Mandates that the company **"does not use"** any plant and machinery previously used for any purpose
- On a year-on-year basis, use of second hand plant/machinery (with the exception of certain imports) in excess of 20% in value whether invalidates 15% CTR?
  - Value of second hand plant and machinery – FMV or depreciated value?
- Restrictions whether limited to machinery or plant or intangibles as well?
- No restrictions on housing of business activities in previously used building (with exception of buildings previously used as hotel / convention centre in respect of which deduction u/s 80-ID has been claimed and allowed)

CBDT may issue guidelines if any difficulty arises regarding fulfillment of above conditions

15% CTR – Some key issues

- Consequences of default:

  *"Provided that in case of a person, where the option exercised by it under section 115BAB has been rendered invalid **due to violation of conditions contained in sub-clause (ii) or sub-clause (iii) of clause (a), or clause (b) of sub-section (2)** of said section, such person may exercise option under this section"* [Proviso to subsection (5) of section 115BAA]

- Fallback option in case of default of conditions of section 115BAB restricted only to the conditions of:
  - Use of second hand plant and machineries;
  - Use of any building previously used as hotel or convention centre in respect of which deduction u/s 80-ID has been claimed and allowed
  - Not engaged in business other than manufacturing
- Condition of splitting up or reconstruction provided in sub-clause (i) of clause (a) not covered. Does this mean that one will not be able to opt for S. 115BAA if there is a breach of condition of splitting up or reconstruction?

A Broad Decision Matrix for 22% CTR

A Broad Decision Matrix Box : To be or not to be in 22% CTR?

Company	Incentives	ETR	Delta	MAT
22% CTR	No	25.17%	-	No
Small Sized Companies*	Yes	29.12%	3.95%	Yes
Others	Yes	34.94%	9.77%	Yes

Tax Equilibrium for companies claiming incentives			
Particulars	Reference	Small Sized	Others
Income	A	100.00	100.00
Incentives	B	13.5	28
Net Income	C = A - B	86.5	72.00
Tax Rate	D	29.12%	34.94%
Tax Liability	E = C * D	25.17	25.17

Companies claiming deduction/exemption effectively of more than 28% on total income unlikely to opt for 22% CTR. Accordingly, Companies not having significant MAT credit or brought losses attributable to specified deductions, should opt for 22% CTR, if the total deduction/exemption claimed by it is less than 28% (13.5% for small sized company)

Where turnover in FY 2017-18 does not exceed INR 400 crores (-USD 57 Million)

Accounting aspect – Impact on deferred tax

Accounting aspect
Impact on opening deferred tax

- A Co is planning to opt for 22% CTR in FY 2019-20
- Below table depicts the deferred tax position:

Particulars	Reference	Amount in INR
Taxable temporary difference as on 31 March 2019 which is expected to reverse in 2019-20 and 2020-21	A	10,00,000
Deferred tax liability as per old rate 35%	B	3,50,000
Decrease in rate due to opting for 22% CTR	C	10%
Decrease in deferred tax liability	A X C	1,00,000

Key points to consider:

- Impact of tax rate change on measurement of deferred tax asset and liability
- Impact on accounting for existing MAT credit (recognized or unrecognized) in the financial statement

Case Studies

Case Study 1 - Additional depreciation and brought forward losses
Whether existing regime is more beneficial than 22% CTR?

- A Co was claiming deduction under section 10AA/80-IA upto FY 2018-19 which was the last year of claiming such deduction
- Further, it has depreciation, brought forward losses, unabsorbed depreciation (brought forward and current) as follows:

Particulars	Reference	Amount in INR
Business loss (from business qualifying for S. 10AA/80-IA deduction under ITA)	A*	10,000
Unabsorbed depreciation (other than additional depreciation)	B	20,000
Unabsorbed additional depreciation	C	5,000
Current year depreciation	D	50,000
Current year additional depreciation	E	10,000

- In the next slide, we have enumerated the comparative position between existing regime and 22% CTR in respect of 2 scenarios.

***Can the loss of INR 10,000 be deducted if A Co opts for 22% CTR in FY 2019-20?**

Case Study 1 - Additional depreciation and brought forward losses – Whether existing regime is more beneficial than 22% CTR?

Particulars	Scenario 1		Scenario 2	
	Normal rates	22% CTR	Normal rates	22% CTR
Business profits before depreciation claim (from business previously qualifying for S. 10AA/80-IA deduction under ITA)	1,00,000	1,00,000	3,00,000	3,00,000
Less: Normal depreciation of current year	50,000	50,000	50,000	50,000
Less: Additional depreciation of current year	10,000	Nil	10,000	Nil
Taxable Profit	40,000	50,000	2,40,000	2,50,000
Brought forward loss set off	35,000 (A+B+C)	30,000 (A+B)	35,000 (A+B+C)	30,000 (A+B)
Total Income	5,000	20,000	2,05,000	2,20,000
Effective Tax Rate	34.94%	25.17%	34.94%	25.17%
Tax Payable	1,747	5,034	71,627	55,374
Whether to opt for 22% CTR?	**No** (Difference of Income is Rs 15,000 which pertains to additional depreciation and b/f loss pertaining to additional depreciation. This is much greater than 28% break-even)		**Yes/May be** (subject to MAT credit or other Incentives). Impact of additional depreciation is Rs. 15,000. This is lesser than the 28% break-even)	

- Projected income will have a bearing on the decision of whether to opt for 22% CTR or not
- **The impact in the above situation may still undergo a change if A Co is a tax holiday unit eligible to claim deduction u/s 10AA/80-IA even in FY 19-20 and subsequent years**

Case Study 2 – Claiming 22% CTR despite availability of deduction u/s 80-IA

- I Co. has two units, Unit 1 which qualifies for S.80-IA deduction and Unit 2 is non-qualifying.
- Unit 1 is within tax holiday period and it incurs losses in FY 2018-19 of Rs. 100.
- The said loss stood set off against profits of Unit 2 in the same year. Thus, there is no loss carried forward to FY 19-20
- For year 2019-20 the income of Unit A and B is 100 each. I Co wishes to evaluate if it should opt in for S.115BAA in FY 19-20.
- Had I Co continued to be taxed as per existing provisions its income would be computed as under:

Particulars	Unit A	Unit B
Total income before	100	100
80-IA deduction [Profits - losses of FY 18-19 notionally set off as per S. 80-IA(5) i.e. 100-100=0]	Nil	NA
Taxable profits	100	100
Total taxable profits (A)	200	
Is % of deduction claimed > 28% of income/ profits (Refer slide 15)	No	
Tax u/s 34.94% on A	69.88	
Tax u/s 25.17% on A	50.34	

- **Due to operation of provision such as S. 80-IA(5), the taxpayer is not entitled to get meaningful deduction.**
- **Accordingly, such taxpayer will be at par with the taxpayer who has no incentive deduction and may therefore wish to switch over to 22% CTR.**

Case Study 3 - Setting up new domestic manufacturing company

Particulars	FY 2020-21	FY 2021-22	FY 2029-30
Revenue from Operation	-	2,000	20,000
Interest Income	60	-	500
Capital Gains on Sale of Assets	-	100	500
Products Manufactured	None	2 Products	50 Products
Fresh Capital Investment	Capital WIP	10,000	1,00,000

FY 2020-21

- Whether 15% CTR available on interest income during pre-commencement period?

FY 2021-22 up to FY 2029-30 and beyond

- Manufacturing commenced before 31 March 2023. Hence 15% CTR applicable
- 15% CTR applicable on profit from all operations – will it include units set up beyond 31 March 2023?
- Interest income from surplus funds - taxable @ 22% on gross basis
- Short term capital gains on sale of asset - taxable @ 22%

Case Study 4 - Whether existing regime beneficial than 22% CTR? S. 35AD of ITA and 22% CTR

(Amount in INR)

Particulars	FY 2018-19
Revenue from Business operations	1,00,000
Less: Expenditure incurred on business operations	(75,000)
Operating Profit/ (Loss)	25,000
Less: Capital Expenditure eligible for deduction u/s 35AD	(1,75,000)
Taxable Profit/ (Loss)	(1,50,000)
MAT credit available	Yes

What is the measure of brought forward loss attributable to deduction u/s. 35AD if company opts for 22% CTR in F.Y. 2019-20?	
Rs. 1,50,000	Entire amount of capital expenditure which contributed to loss?
Rs. 75,000	On the principle of beneficial allocation, loss represented by revenue expenditure is protected.
Rs. 1,05,000	Loss is contributed pro rata in the ratio of 7:3 by capital expense (Rs. 1,75,000) as also revenue expense (Rs. 75,000)

- Whether choice of claim of S. 35AD is onerous? Can be withdrawn for F.Y. 2018-19?
- Impact of denial of S.35AD on calibration of WDV for depreciation?

Case Study 5 - SEZ units in different phases of deduction vs Section 115BAA

Particulars	Company A SEZ unit in 1 to 5 year of operations	Company B SEZ unit in 6 to 10 year of operations	Company C SEZ unit in 11 to 15 year of operations	Section 115BAA company
Total income before deduction u/s 10AA	10,000	10,000	10,000	10,000
Less: S. 10AA Deduction	10,000	5,000	1,000*	NA
Total Income	Nil	5,000	9,000	10,000
Total normal tax (A)	**Nil**	**1,747**	**3,144**	**2,517**
Book Profit	10,000	10,000	10,000	10,000
MAT Liability @ 17.47% (B)	**1,747**	**1,747**	**1,747**	**NA**
Tax Payable (Higher of A and B)	1,747	1,747	3,144	2,517
MAT credit set-off	**NA**	**NA**	**1,397**	**NA**
Net tax payable	1,747	1,747	1,747	2,517
MAT credit carried forward for the year	**1,747**	**Nil**	**Nil**	**NA**

*Assuming, Company's C projection of reinvestment is only 10% of total income before S. 10AA deduction

Case Study 6 - SEZ unit & Non-SEZ unit structure

Particulars	SEZ Unit	Non SEZ Unit 1	Non SEZ Unit 2
Income	10,000	10,000	25,000

Particulars	Existing Structure (34.94%)	Existing Structure (22%CTR - 25.17%)	Post Restructuring (Demerger)	
			SEZ Unit + Non SEZ Unit 1 (34.94%)	Resultant Company (Non SEZ Unit 2) (22% CTR - 25.17%)
Income of SEZ Unit	10,000	10,000	10,000	-
Income of Non SEZ Unit	35,000	35,000	10,000	25,000
Less: S. 10AA Deduction	10,000	NA	10,000	-
Total Income	35,000	45,000	10,000	25,000
Total normal tax (A)	**12,229**	**11,327**	**3,494**	**6,292**
Book Profit	45,000	NA	20,000	NA
MAT Liability @ 17.47% (B)	**7,861**	**NA**	**3,494**	**NA**
Tax Payable (Higher of A and B)	12,229	11,327	3,494	6,292
Total tax payable	**12,229**	**11,327**		**9,786**

Careful evaluation of restructuring/planning opportunities may help optimise taxes for the group

Illustrative cases where deferment of 22% CTR may be preferred & way forward

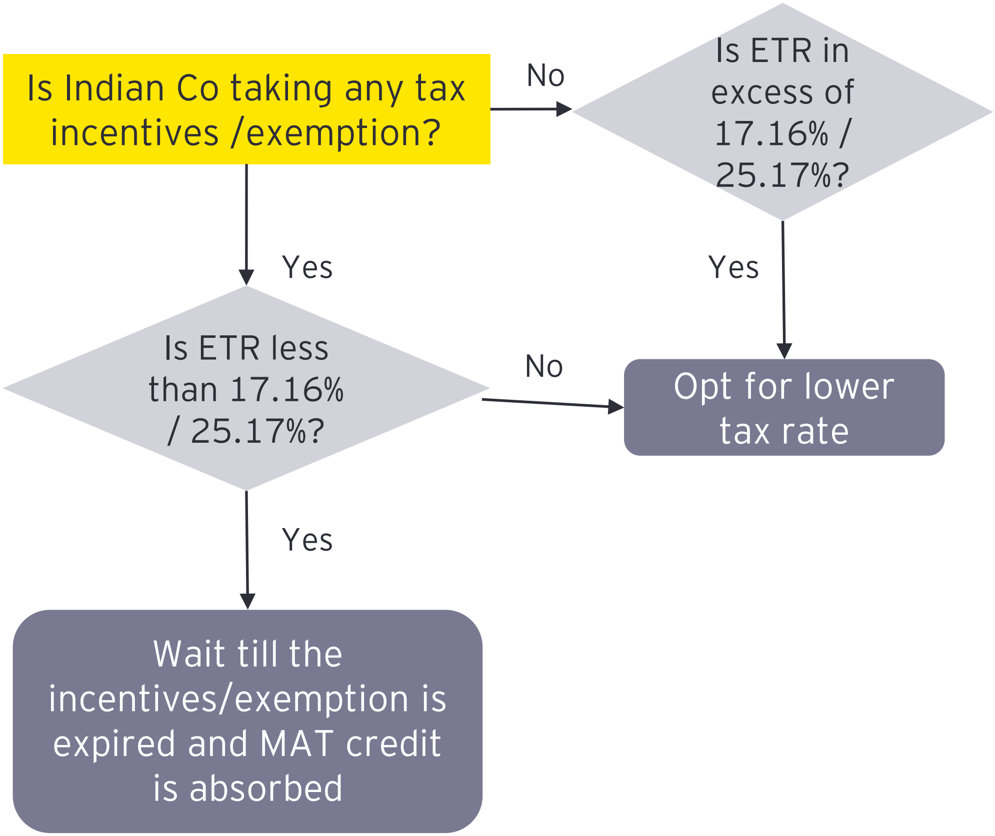
Illustrative cases where deferment of 22% CTR may be preferred

- Companies with significant brought forward MAT Credit
- Companies enjoying significant incentives/exemptions (more than 28% of total income)
- Company with huge carried forward losses attributable to incentives which can control ETR up to MAT rate
- Insolvency and Bankruptcy Code (IBC) company who has shield of huge business and depreciation loss for MAT as also normal tax.

Timing of opting for the 22% CTR would be critical

Way forward - Decision Matrix for 15%/22% CTR

When to opt for lower tax rate ?



Tax matters to be evaluated

- Comparison of existing ETR (including eligibility to claim incentives/exemptions) vis-à-vis revised lower ETR
- Potential past uncertainties in relation to allowability of exemptions / incentives
- Evaluation of availability existing MAT credit, if any
- Carry forward past tax losses arisen due to specified incentives and exemptions
- Evaluation of the precise year for exercising option for lower tax rate
- Deferred tax impact
- Company vs LLP
- DDT position
- Hiving off/separation of business for ETR planning

Evaluation to be based on facts in the year the option is to be exercised as well as projections for subsequent years


Questions?

Thank you

Pramod Achuthan
Partner, Ernst & Young LLP
Tel: + 91 20 4912 6012
Cell: +91 98231 59107
Email: pramod.achuthan@in.ey.com

Gaurav Agarwal
Senior Consultant, Ernst & Young LLP
Tel: +91 20 4912 6000 - Extn: 64408
Cell: +91 9579710139
Email: gaurav4.agarwal@in.ey.com