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Parthasarathi Shome: Taxation research: Emergence and progress

Research on tax issues that may aid policy formulation, implementation

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Formulation of tax legislation and its subsequent administration have suffered persistent lack of analysis prior to implementation. Recently emerging in-depth research carried out by independent tax professionals may be about to break the mould. Three of seven papers are highlighted here in a two-part series, today's focusing on tax policy and the next on tax implementation.

The first is reduction of corporate income tax (CIT) rate to 25 per cent pari passu with scaling back tax incentives. Mukesh Butani et al point out that a high proportion of revenue forgone reflects export oriented units in the IT sector, SEZs, and infrastructure including power, bridges, highways, water treatment and industrial parks. The main question therefore is whether these sectors are willing to sacrifice incentives.

Butani points to dispersion of average effective tax rate of 23 per cent between 26.89 per cent for smaller companies (profit before tax up to Rs 1 crore) and 20.68 per cent for companies at Rs 500 crore or more. They blame this on phasing out profit linked deductions, as well as tax concessions being enjoyed disproportionately by larger companies. They clarify that companies that do not claim major tax incentives and pay taxes under normal provisions will benefit from CIT rate reduction with greater profits available for labour deployment and distribution to shareholders.

By contrast, companies claiming large tax incentives and consequently paying minimum alternate tax (MAT), may not enjoy immediate changes in tax liability since they would continue to pay MAT until tax incentives expire or phase out. During the four-year phased rate reduction, decrease in CIT tax rate would correspondingly increase MAT credit for such companies; consequently, they could accumulate more MAT credit, and more tax paid in advance. Eventually, such accumulated MAT credit could be used to mitigate future tax liability as incentives cease to exist.

Butani questions scaling back accelerated depreciation since he feels it is merely a timing issue for revenue receipt. He also points to challenges in removing socio-economic or area based incentives including those related to bifurcation of Andhra Pradesh. However, as incentives decrease, he admits litigation over incentives should reduce.

Butani recommends a more cautious approach, through more graduated phase out of incentives, differentiating sectors and locations, and initiating sunset clause from FY 2019-20. He cautions against adverse impact on capital formation; thus accelerated write off of capital investment for industrial and infrastructure activities should not be curtailed. He also asks for a review of the continuing need for MAT when headline CIT rate itself is 25 per cent. He remains in favour of continuing incentives for small and medium enterprises to reduce prevailing inequity.

Moving on to Dividend Distribution Tax (DDT), Indraneel Chaudhury et al recount the history of tax treatment of dividends internationally and in India. Prior to 1997, dividend was taxable in India in the hands of recipient at the normal individual income tax rate. The 1997 DDT exempted dividends in the hands of shareholders and began collecting it from companies, its current rate being 20 per cent. South Africa had a similar tax but removed it in 2012 as the perception grew that its CIT rate was higher than competitor countries.

Chaudhury posits that the economic burden of DDT ultimately falls on shareholders. They also bear an additional burden of disallowance of expenditure incurred in relation to dividend income (since such income is exempt in the hands of shareholders). On the other hand, If DDT is seen as tax payable by a company, then CIT rate (inclusive of DDT rate) is 45 per cent, too high internationally. He also points to deleterious cross-border effects. Since DDT is statutorily paid by a company (and not shareholders), beneficial tax rates for shareholders in any tax treaty cannot be availed either by shareholders or company, rendering those provisions of the treaty otiose. He also critiques DDT on grounds of cascading over multi-tiered corporate structures, and horizontal inequity since it falls on companies and not partnerships and others.

Hence Chaudhury recommends reverting to the classical system of taxing dividends at the hands of shareholders albeit at a reduced rate of 10 per cent. For early tax collection, a company may be required to withhold tax while paying dividends.

In a third paper, P V Srinivasan addresses remaining challenges of the proposed GST. He points towards possible disputes over the event of taxation, classification, value, place of supply and applicable rates that would continue under goods and services tax (GST). He also anticipates disputes in fiscal federal relations since GST Council decisions will not be binding leaving scope for non-harmonisation or divergence in the adoption of tax base and rates. He criticises the proposed one per cent tax on interstate trade whose revenue will be retained by exporting states.

Continuing to exclude petroleum will result in double cascading because petroleum industry cannot avail input tax credit (ITC) while neither can goods or services using petroleum get ITC for tax paid on petroleum. He calculates that prevailing contribution of petroleum and petroleum products is 20 per cent of indirect tax revenue which will stay outside the GST base and later consensus from states is not foreseen. Collectively, he calculates by listing and analysing all uncovered elements that 60 per cent of GDP will remain outside the scope of GST.

PVS asserts that exempting part of the financial services sector will cause distortions as banks and financial institutions will be unable to achieve operational efficiency through outsourcing of their business process operations to service providers reflecting, once again, no allowable ITC. For construction industry, construction is likely to continue to be defined as work contract. This would require separation of goods from services vitiating a quintessential characteristic of a good GST. He also mentions distortions emanating from rental of residential housing if it is kept outside GST since ITC would not be allowed to the supplier. PVS' level of aspectual detail surpasses most available treatises.

These papers are emanating from a corner in Bengaluru that is bringing tax experts to exchange ideas under the International Tax Research and Analysis Foundation (ITRAF). Its website www.itraf.org may be of interest to policy makers and researchers.