Reflections on India’s Corporate Tax Rate Cuts

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Introduction
Last fortnight, India by way of a Presidential Ordinance unexpectedly unveiled a new corporate tax rate structure. Given that the annual Union Budget exercise was presented in July, the announcement was unscheduled particularly since Ordinance route is rarely resorted for such changes. Nonetheless these changes are in line with the recent spate of measures unveiled by the GOI to address the perceived economic stagnation and induce economic growth. The extent of change, however, is profound and fundamentally changes the ways companies do business with or in India.

Appreciating the new corporate tax rate of 22%

One of the major changes is a new corporate tax rate structure for Indian incorporated companies who have an option to switch from the current rate of 25%/30%[1] to 22%[2]. The condition attached to this option is that the company must forego all the present and future tax exemptions under enumerated cases. These exceptions cover units operating under special economic zones [SEZ], units operating in notified backward areas, exemptions arising on account of accelerated investment in plant and machinery, etc. In order words, the new corporate tax rate sets the tone for an exemption-free regime, often viewed as distorting and bringing down the effective tax rate of the Country, which presently is around 23% with complex tax incentives.

The new rate structure, though optional, has multifarious impact on the manner in business enterprises are structured in India. Take an illustration of a business with an SEZ unit. India unveiled in 2005 a new legislatively-sanctioned scheme for SEZ to promote units exclusively engaged in export of goods and services. Initially, the SEZs were unconditionally exempt from corporate tax. However, in 2012, India introduced a Minimum Alternate Tax (MAT) of 18.5%[3] which is akin to a tax on book profits. This effectively diluted the rationale for an SEZ, though MAT was permitted to be carried forward to set-off against future profits. The new corporate rate brings companies with domestic business at par with those engaged in exports and thus incentivizes doing business without export orientation.

Also noteworthy is that there are no corresponding changes in the tax rate for foreign company or branches. They continue to suffer tax at 40%.[4] Even if the dividend distribution tax of 15%[5] is factored, ownership of Indian company is not a tax-inefficient choice compared to foreign companies operating in India. In any case, the India Tax law categorically declares that higher tax incidence on foreign company is not considered as ‘less favourable’ so as to be entitled to treaty benefits. Put differently, upon holistic consideration of the relevant variables, there is a disincentive to operate under a non-residence model for companies doing business in India. It is speculated that this change alone shall force foreign bank branches to look at the subsidiarization route for operating in India.

This effective corporate tax incidence in India now matches with the average corporate tax rate of OECD countries. This clearly reflects India’s resolve to position itself in the league of developed nations, institute tax-competitiveness and leave adequate profits for expansion, increasing shareholder return, repatriation etc.

Larger economic perspective

Besides an across-the-board tax rate deduction, a new corporate tax rate of 15%[6] has been introduced for Indian companies which will be incorporated after October 1 and which commence manufacturing operations up to March 2023. No tax exemptions would be available to such companies and, more crucially, MAT is not applicable. In other words, manufacturing activity is topmost priority for India keeping in mind its avowed policy of ‘Make-in-India’ with an underlying intent to make it as a global manufacturing-hub. This, besides the impact on employment and meeting domestic demand, with reduced reliance on imports and is viewed as a game changer.

With growing middle class and per capita income coupled with developing infrastructure, skilled & semi-skilled workforce, several billion dollars of foreign investment by the likes of Amazon, Walmart, Ikea, etc. is a living testimony to the enhanced economic viability of India. The increasing number of unicorns from innumerable start-ups finding sustenance in India corroborate this proposition. An added thrust on manufacturing, through a concessional tax-rate seems like a well calculated policy with an expectation that the increased economic activity will match the shortfall which may arise due to the reduced tax rates.

This rate cut also needs to be appreciated in the light of other recent changes allowing 100% FDI under the automatic route in ‘contract manufacturing’, hitherto policy for which lacked clarity. In other words, there is no regulatory approval required for MNEs before investing in contract manufacturing opportunities. Multinational groups looking to relocate from China owing to the ensuing trade-wars, or even otherwise deciding on manufacturing base cannot ignore the reinvigorated Indian economic environment with these changes.

Summary

The above changes have accompanied accelerated depreciation on automobiles and passenger vehicles purchased after August 23 as a one-time measure to address the slowdown in the auto sector. The changes include roll back of the surcharge levy on Foreign Portfolio Investors and dilution for tax on individuals on capital market transactions announced in the July budget, which turned the mood and market sentiment. Change in consumer-preferences have brought in dynamic market-upheavals in the traditional economic outlook of India. This has led India to be upbeat and promote both local entrepreneurship while also woo international manufacturing giants with a clear idea wake the animal spirits for promoting economic activity. From an investment-treaty and tax-treaty perspective, therefore, one can expect inbound investment to be increasingly scrutinized by the revenue officers who will look to renegotiate / apply the Limitation-of-Benefits clause to check genuine investment in India.

END NOTES

[1] Depending upon whether the turnover is less than or more than INR 4bn. The effective tax rate (with surcharge and cess) is 29.12%/34.95%.

[2] The effective tax rate is 25.17%.

[3] The effective tax rate was 21.55%. The current MAT rate is 15% and effective rate is 17.47%.

[4] The effective tax rate is 43.68%.

[5] The effective tax rate is 20.56%.

[6] The effective tax rate is 17.01%.