Corporate tax rate cut and savings thereof

Contact:

Madan Sabnavis
Chief Economist
madan.sabnavis@careratings.com
+91-22- 6837 4433

Darshini Kansara
Deputy Manager – Industry Insights
darshini.kansara@careratings.com
+91-22- 6837 4345

Mradul Mishra (Media Contact)
mradul.mishra@careratings.com
+91-22-6837 4424

In continuation with the series of measures announced to address the growth slowdown, the Finance Minister on Friday (September 20, 2019) announced the fourth tranche of measures which pertain to the long standing demand of cut in corporate tax rates. Of all the recent measures announced to tackle the domestic economic slowdown, this is considered to be substantial in terms of economic and fiscal impact, as has been evidenced by the market reaction.

The Government passed the Taxation Laws (Amendment) Ordinance 2019 which includes key change on the corporate taxation along with other fiscal measures. The salient features of the amendments are:

Corporate tax reduced for all companies, subject to conditions:

- **Reduction in corporate tax rate:** From FY20, the corporate tax rate for domestic companies has been slashed to 22% from the earlier 30% (or 25%) *subject to the condition that the company will not avail exemptions/incentives.* The effective new tax rate for corporates shall be 25.17% including the surcharge and cesses.
- **Lower Tax rate:** For a company incorporated on or after October 1, 2019 and making fresh investments in manufacturing will also have an option of paying corporate tax at 15% (without availing exemptions). It is to be noted that such a company must commence their production on or before March 31, 2023.
- **No MAT:** Companies that have availed the benefit of lower corporate tax rates (22% for all companies and 15% for new manufacturing companies) shall not be required to pay minimum alternate tax (MAT).
- **Lower MAT:** The applicable rate of MAT for the companies which want to continue availing the available exemptions have been reduced from 18.5% to 15%.

In this study, we analyse the impact of this new tax regime on a set of companies based on the FY19 results. The purpose is to look at the companies which had positive PBT in FY19 and assess the tax savings with the application of the new tax rate of 25.17%. The study is based on 2,377 companies from the aggregate sample of 3,170 companies which had positive PBT. The cumulative profits before tax were about Rs 8.84 lakh crores in FY19.

Some highlights of the study

- Total tax paid for FY19 by 2,377 companies was Rs 2.37 lakh crore for FY19 with an effective tax rate of 27.5%.
- The incremental investments (incremental sum of GFA and work in progress) of this sample set were Rs 2.96 lkh crore.
- Of these companies, 1,192 companies paid taxes at a rate higher than 25.2% during FY19
- If these companies had paid tax at 25.17%, the industry would see a savings of Rs 41,555 crore.

Which industries would gain?

Table 1: Top 10 industry gainers (Rs cr)

Industry	Tax Savings	Share in Tax savings (%)	Capital Formation
Banking, Finance & Insurance	17,679	42.5	7,229
Crude oil	1,559	3.8	20,724
Auto & Ancillary	2,073	5.0	14,223
Iron & Steel	2,528	6.1	4,995
FMCG	2,500	6.0	5,417
Mining	2,389	5.7	4,721
Capital Goods	1,791	4.3	2,702
Chemicals	1,277	3.1	8,007
Power	1,172	2.8	50,289
Infra	1,101	2.6	1,372
Sub-total	***34,069***	***82.0***	***119,679***
Total (all industries)	**41,555**	**100.0**	**170,706**

Source: AceEquity, CARE Ratings

- The top industries comprising 400 companies included in the table above accounted for 82% of total tax savings in this scenario.
- The financial sector was the dominant one with share of 42.5% followed by iron and steel, FMCG, auto and mining each of which had shares of above 5%.
- Total incremental asset formation by these companies was Rs 1.70 lkh crore and these industries accounted for Rs 1.20 lkh crore i.e. 70%.

What could go into new investment?

- Tax savings from the financial sector are unlikely to be channelled for fresh investment which rules out around 42% of total tax savings.
    - However to the extent that these surpluses are transferred to the reserves which are considered when calculating the capital adequacy ratio, the ability to lend for banks would increase. Based on FY19 data, close to Rs 12,000 crore would be savings of private banks which can at a CRAR of 10% deliver credit of around Rs 1.2 lkh crore if fully transferred to reserves with no other conditions changing.

- Power sector already has high investment and the gain of Rs 1,172 crore may not be very significant. Typically borrowings would be used to finance the same.
- Auto-segment which is witnessing lower production in successive months may not be in a position to increase investment presently.
- Hence, excluding finance and auto, around half of these savings could possibly go in for further investment.

What are the alternatives?

- Higher dividend payments could be a result of this tax measure which is good for the shareholders.
- Earnings indicators would be positive as these funds would get included in the reserves that will improve the RONW.
- Some companies may use this gain for repaying debt based on the cost considerations.
- It may also be used for furthering R & D is sectors such as healthcare and EVs in auto.
- In case of PSUs which dominate the power and crude oil segments, the tax savings could be used in the disinvestment process where typically there are cross investments made by some of the companies. Hence it may be viewed as a transfer of resources to the government.

Concluding remarks

Companies paying presently an effective tax rate of above 25.17% could be potential gainers in case they shift to this new tax regime after weighing in the net advantages of losing out on other exemptions in the new dispensation. To the extent that the tax savings are highest for the financial sector the amounts are likely to move to the reserves or partly distributed to the shareholders as dividend based on the decisions taken by individual Boards. However this may be used for shoring up capital which can in turn serve as the base for further lending. Overall maybe half of the total savings as per this sample could be available for investment and it would be interesting to see as to how these funds get deployed. Such decisions may be taken at the end of the year after companies assess their profit and demand conditions as both are important factors. It may be surmised that a part of these gains would definitely be used for investment but it is more likely to happen post 2020.

CARE Ratings Limited (Formerly known as Credit Analysis & Research Ltd)
Corporate Office: 4th Floor, Godrej Coliseum, Somaiya Hospital Road, Off Eastern Express Highway, Sion (East), Mumbai - 400 022. CIN: L67190MH1993PLC071691
Tel: +91-22-6754 3456 I Fax: +91-22-6754 3457
E-mail: care@careratings.com I Website: www.careratings.com

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