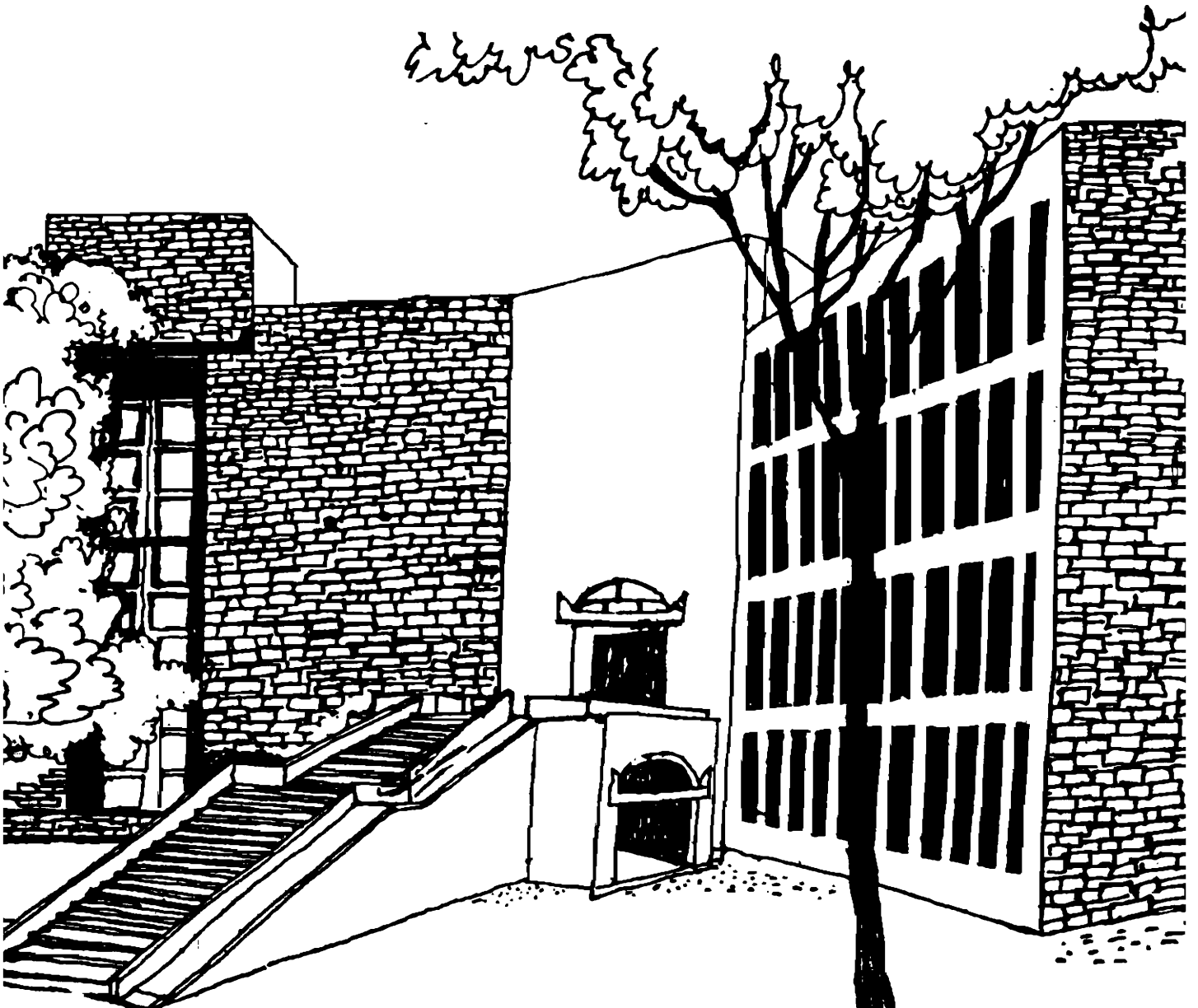




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Working Paper



**DIRECT TAX PROPOSALS IN THE UNION BUDGET
1997/98: A PRELIMINARY ANALYSIS FROM A
CORPORATE FINANCE PERSPECTIVE**

By

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Direct tax proposals in the Union Budget 1997/98: A preliminary analysis from a corporate finance perspective

By

N. Venkiteswaran

Abstract:

The Union Budget 1997/98 has significant implications for corporate investment, financing and dividend decisions. While the lowering of corporate tax rates places a premium on efficiency and profitability, lowering of personal tax rates and the proposal for complete tax exemption for dividend have the potential to lower cost of capital. Company managements may have to devote more explicit managerial attention to dividend policy on account of likely increase in investor pressure for stepping up dividend on the one hand and the imposition of 10% tax on distributed profits on the other. Preference shares are likely gain a new lease of life as a financing instrument.

Direct tax proposals in the Union Budget 1997/98: A preliminary analysis from a corporate finance perspective

By

N. Venkiteswaran

The landmark proposals relating to direct tax in the Union Budget 1997/98 have significant implications for the investment, financing and dividend decisions of the corporate sector. While the corporate sector's response in several dimensions may evolve over time and hence could also be influenced by other developments, in certain respects one could expect a more immediate and coherent response. The behaviour of corporate sector, it may be noted, would be influenced not only by the changes proposed in the corporate tax provisions, but equally significantly by the proposals relating to personal taxation as well. The main proposals relating to corporate and personal taxation and their likely impact on the aforesaid key decision areas are examined below.

Reduction in corporate tax rates

The reduction of 8 percentage point proposed in the corporate tax rate for domestic companies, (through reduction of basic tax rate to 35% from 40% and abolition of the 7.50% surcharge thereon) would boost the post-tax earnings by 14% at the margin. Since typically the *average tax rates* (i.e., the ratio of tax liability to reported or book profits) for most companies turn out to be lower than the actual marginal rates, the effect of the 8% tax reduction would have a somewhat diminished impact on *reported* profits. Thus companies with average tax rates of 25% and 30% would find their reported after-tax profits increasing by 6.20% and 8% respectively whereas a company with an average tax rate of 50% would have its net profits up by 18.6%. Needless to state, corporate cash flows would also see a genuine increase. The

increase in post-tax profits and cash flows, together with the lower cost of capital discussed later, would boost market valuation, the extent of increase depending on the relative significance of the impact of the tax reduction in individual companies.

Investment in new projects

Regarding new projects, while the lower taxes would augment operating after-tax cash flows from projects, this would also reduce the value of tax savings from depreciation tax shield, thus bringing down the overall gains. The extent of gains in present value terms would depend on the quantum and timing of operating cash flows (OCF) and the income tax depreciation rates for the specific asset(s) in question. The impact is illustrated with reference to a hypothetical project of Rs. 1000 lakhs with a life of 10 years (and no salvage value) and eligible for the normal income tax depreciation rate @ 25%. The impact is examined for both the pre-budget tax rate of 43% and the new rate of 35%, under 2 scenarios of pre-tax operating cash flow generation @ 25% and 35% per annum during the 10 year period.

As quantified in Table 1 for the illustrative project, the overall DCF (discounted cash flow) returns, whether expressed in internal rate of return (IRR) or net present value (NPV) terms, would show decent increases with the new tax rates of 35% and the gains will be sharper, the greater the profitability of the project as represented by the pre-tax operating cash flows (OCF). At a 14% discount rate, the present value (PV) of depreciation tax shield (DTS) would be lower by about 5% of the investment outlay and the overall positive gains would be after adjusting for this loss.

TABLE: 1

(Rs. lakhs)		Old tax rate@ 43%	New tax rate @ 35%	Difference	Pre-budget	Post-budget	Difference
1	IRR	14.42%	15.89%	1.47%	22.32%	24.52%	2.20%
2	NPV @ 14%	14.75	68.57	53.82	312.07	407.62	95.55
3 NPV analysis @14%							
a	PV of outflow	-1000.00	-1000.00	0.00	-1000.00	-1000	0.00
b	PV of OCF	743.30	847.62	104.32	1040.62	1186.67	146.05
c	PV of DTS	271.45	220.95	-50.50	271.45	220.95	-50.50
4 NPV change in relation to the project cost							
a	Overall			5.38%			9.56%
b	OCF			10.43%			14.61%
c	DTS			-5.05%			-5.05%

Notes:

- a) 14% discount rate is equivalent to the weighted average cost of capital (WACC) with the cost of equity @ 22 % and after-tax cost of debt @ 10% and a debt-equity ratio of 2:1.
- b) OCF: Operating cash flows
- c) DTS: Depreciation tax shield

It goes without saying that the lowering of the tax rates places a premium on performance and profitability. In view of this, it is believed that the corporate sector would begin to lay greater emphasis on cost reduction and other measures that would enhance near term profitability. By the same token, there will be less emphasis on undertaking tax-driven mega projects, i.e., investments predominantly motivated by the urge to save taxes. The PV of DTS is down to 22.1% of the project outlay compared to 27.1% before, implying that operational cash flows have to increase to 77.9% of the project cost from 72.9% before the budget in present value terms to justify the investment. This is a far cry from the early nineties, when the PV of DTS

would have helped the same company to recoup as much as 43.6% of the investment outlay (through savings in taxes from, say, its current or mainstream operations) thereby encouraging to undertake even operationally unattractive projects.

Weighted deduction of capital expenditure for research.

A weighted deduction of 1.25 times the capital expenditure (capex), excluding land and buildings, incurred for in-house research is proposed to be allowed as deduction under a new sub-section 35 (2AB) to the Income Tax (IT) Act for notified industries such as pharmaceuticals, telecom and electronics and computers. This scope to recover 44% of the capex in the year of expenditure through tax savings should encourage more aggressive research efforts.

Incentive for cost reduction

It is also quite likely that the corporate sector would move away from the traditional expense-loading culture, when there was every incentive to charge off as expenses in the company's books on the ground that government was financing (bearing) 55%-60% of the expenses! There is now greater incentive to slash costs. In view of the significant reduction in personal taxes as well, discussed below - take home pay of most tax-payers would increase by about 10% to 15% - it is possible that corporate personnel costs would be reined in. Moreover there would be greater transparency in accounting employee remuneration as part of the regular compensation.

A consequence of the tax rate reduction is that several industries with regulated pricing such as fertilisers, electricity etc. would see some reduction in regulated/retention prices, that would have some bearing on the subsidy bill of the government.

Revision in provisions relating to MAT

The budget proposes carry forward and set-off facility in respect of the minimum alternate tax (MAT) payable on 30% of the book profits. Thus MAT would amount to an advance tax rather than additional tax, and the carry forward facility is available for a period of 5 years from the year of incidence of MAT. With the reduction in corporate tax rates, the effective MAT rate is 10.50% compared to 12.90% earlier. Apart from these, it is specifically provided that export profits subject to exemption under section 80 HHC would be exempt from the application of MAT.

Reduction in personal taxation and impact on cost of capital

The across-the-board reduction in personal taxation and in the maximum marginal rate to 30% (from to 40% before) could have a downward effect on the return expectations in the economy and hence for financing cost for the industry. Since investors from the household sector (i.e., retail investors) are concerned about the after-tax rather than pre-tax income, the lowering of personal tax rates carries with it the potential to reduce the pre-tax returns without affecting the post-tax income streams of the investors. Of course, return expectations in the economy are determined by a host of other factors such as inflationary expectations, supply/demand factors, government's borrowings etc. These factors remaining the same, lower personal tax rates would have the effect of lowering pre-tax coupon payments as well. Similarly a good portion of the 10% to 15% increase in the disposable income of the middle/high income group arising from the tax cuts would be seeking investment avenues, thereby increasing the supply of investible resources. This could again lead to downward pressure on interest rates. This is of course, subject, to effective inflation management and the government itself containing its own borrowing programmes. The downward interest rate movement would possibly start with the bank deposit rates, the benchmark rates for the household sector, and could quickly be felt across the array of other rates in the economy.

Declining interest rates would have significant positive effect on the stock market valuation. This would be on account of two factors of lower equity discount rates and as already noted, higher corporate profitability. Decline in interest rates would translate itself into corresponding lower return expectations of investors from equity as well, thereby leading to lower overall cost of capital. Another factor that should help in lowering the cost of equity is the proposal to exempt completely from taxation dividend income at the hands of investors (as discussed below). Also lower interest rates would flow through the corporate bottom line, doubly aided by the lower corporate tax rates as well. The increase of the stock market valuation and its sustainability would, needless to state, depend on the extent of interest reduction in the economy and the stability of the rates at lower levels.

Taxation relating to dividends

The budget proposes two important changes relating to dividends: imposition of a 10% dividend tax on companies on their distributed profits (dividend payments) under a new section 115-O and granting complete tax exemption for dividend income at the hands of the recipients under a new section 10(33). While the tax exemption at the hands of the recipients might suggest more liberal dividend distribution by the corporate sector, the tax on distributed profits would act as a countervailing force.

The 10% corporate tax on dividend, effectively, increases the marginal corporate tax rate of 35%, the exact incidence depending on the pay-out policies of individual companies. The following table (Table 2) gives a comparison of the overall impact on the average corporate tax, of the budget proposals of lower corporate tax and the dividend tax vis-à-vis the pre-budget scenario.

TABLE 2 : IMPACT OF CORPORATE TAX RATE CHANGES (INCLUDING DIVIDEND TAX)								
I PRE-BUDGET AVERAGE TAX RATES →								
II CORRESPONDING POST BUDGET AVERAGE TAX RATES FOR VARIOUS PAY-OUT RATIOS								
a	For a dividend pay-out ratio of----->	0.0%	16.3%	20.3%	24.4%	28.5%	32.6%	35.0%
b	For a dividend pay-out ratio of----->	10.0%	17.1%	21.1%	25.2%	29.2%	33.2%	35.7%
c	For a dividend pay-out ratio of----->	20.0%	18.0%	21.9%	25.9%	29.9%	33.9%	36.3%
d	For a dividend pay-out ratio of----->	25.0%	18.4%	22.3%	26.3%	30.3%	34.2%	36.6%
e	For a dividend pay-out ratio of----->	30.0%	18.8%	22.7%	26.7%	30.6%	34.6%	37.0%
f	For a dividend pay-out ratio of----->	40.0%	19.6%	23.5%	27.4%	31.3%	35.3%	37.6%
g	For a dividend pay-out ratio of----->	50.0%	<i>20.5%</i>	24.3%	28.2%	32.1%	35.9%	38.3%
h	For a dividend pay-out ratio of----->	60.0%	<i>21.3%</i>	<i>25.1%</i>	29.0%	32.8%	36.6%	38.9%
i	For a dividend pay-out ratio of----->	70.0%	<i>22.1%</i>	<i>25.9%</i>	29.7%	33.5%	37.3%	39.6%
j	For a dividend pay-out ratio of----->	80.0%	<i>23.0%</i>	<i>26.7%</i>	<i>30.5%</i>	34.2%	38.0%	40.2%

As can be seen, for virtually any pre-budget average rate scenario, the post-budget overall average tax rate turns out to be lower even with high dividend pay-outs; particularly so for companies with higher tax outgo previously. Only in those cases with low tax payments (20-25% levels), and relatively high pay-outs (60%-70%), the dividend tax incidence outweighs the corporate tax savings, leading to increased overall tax incidence in the post-budget scenario. (See figures in italics in the shaded area).

Implications for corporate financing and dividend decisions:

The impact of dividend tax, thus, may not be significant for most companies, and in view of the fact that dividend income is fully exempt at the hands of the recipients, companies are likely to increase distribution particularly because of the increase in disposable profits from the 8% reduction in the tax rates. Since the business level profitability also gets a boost from the tax cuts, there may be a temptation for not increasing pay-out, but rather in reinvesting in business and/or conserving cash

through saving on the dividend tax. Such company managements are likely to see themselves coming under increasing pressure from both retail and institutional investors, keen to enjoy the benefit of tax free incomes, to step up dividend and the it would be a tough task on the part of company managements to convince investors about the rationale of their retention policies as also the genuine shareholder value effects of their investment plans. Since dividend tax is proposed to be made applicable from June 1, 1997, companies would do well to announce 1996/97 dividends as interim dividends and release them before May 31, 1997, rather than wait for the Annual General Meetings usually held in August/September.

The budget seeks to abolish section 80-M of the IT Act that currently exempts intercorporate dividends to the extent of dividend payments; (i.e., dividend receipts at the hands of corporate shareholders to the extent of their own dividend payments), as dividend income is to become fully exempt at the hands of all category of shareholders under the new section 10(33). However in the new scenario, a company that declares dividends to its shareholders out of its own dividend income will still be subjected to the tax on dividend or distributed profits, whereas under the 80-M regime, pass-through dividends were fully tax-exempt until received by non-corporate shareholders. Considering that Indian corporate sector is beset with significant intercorporate and chain holdings by investment companies particularly of promoter groups, dividend distribution by the chain of companies may turn-out to be tax-inefficient by being subjected to dividend tax at every stage. It is possible that some of these corporate holdings could be unwound and restructured so that shareholding is directly vested with promoters in their individual names and/or other non-corporate units. Wherever promoters' holdings are large and that too in their individual names, they would do well to step up dividends and use the tax-free income for fresh investment purposes.

It is also quite possible that preference shares that never took off as a financing instrument in India could see fair amount of interest from retail investors. Since

dividend income is fully tax-exempt, and bond interest income subject to tax (though at the new low rate of 30%) at the hands of the retail investor, the latter might become interested in preference shares. By the same token, banks and financial institutions who have traditionally been financing through loans and bonds should show a keen, new interest in high-dividend yielding shares, typically preference shares, of top class companies again because of the tax-exempt nature of dividend income unlike interest earnings on loans. For issuing companies, on the other hand, the situation would be just the reverse. Since bond interest would be tax-deductible and preference or equity dividend would, on the contrary, be subjected to the dividend tax, (tax paying) companies would have even greater incentive to raise funds through bond issues rather than through any form of shares. This should give rise to new opportunities to structure a variety of instruments with varying coupons and maturities and target them against specific investor class, based on the tax position of the issuing companies/investors.

Take the case of a tax *paying* company which wants to raise funds at, say, a ruling coupon rate of 18%. The effective after-tax cost of funds for the company is 11.70% (tax @ 35%), while a retail investor in the maximum tax bracket of 30% would earn a post-tax return of 12.60% on the same coupon. If the company were to issue preference shares in stead of the bonds, the investor would expect a dividend of at least 12.60% (perhaps even more in view of the higher risk perception in respect of preference shares). With the dividend tax of 10%, the effective after-tax cost works out 13.86% for the preference share, compared to the after-tax interest cost on bond of 11.70%. Thus a tax paying company might continue to prefer a bond issue rather than a preference share issue.

However there may be cases, when an issuing company may find it attractive to issue preference shares rather than bonds. Tax-exempt/low tax companies (export oriented companies and those with large tax losses or capital allowances) could find themselves having little use of interest tax shields. Similarly large infrastructure projects could have little immediate use of interest tax shields in view of low initial

profitability and large capital allowances, and the present value of the tax shields could turn out to be significantly lower. Such companies might find it advantageous to issue preference shares targeting investors with high saving potential and institutional investors (domestic and foreign) rather than bonds. For example if a company undertaking a large infrastructure project issues bonds at, say, 18% and interest tax shield is effectively available only from the fourth year onwards, then the effective after-tax cost could be higher at about 14%(rather than 11.70%), quite comparable with the effective cost of preference shares of 13.86, such that investors' after-tax returns are the same. Since the annual cash outflow for preference shares would even be lower at 14% vis-à-vis the bond coupon of 18%, the company would also be able to conserve cash, very vital in the initial stages of the project.

Non- availability of indexation benefit for bonds

The budget specifically seeks to deny indexation benefits for bonds and debentures; this would straightaway makes investment in deep discount bonds etc. unattractive for the investors. With the maximum personal tax reduced to 30%, investors may find it attractive to invest in high coupon bonds rather than in low zero coupon deep discount bonds and be subjected to risks relating to reinvestment rates. If the investor is in 20% tax bracket, he would be indifferent between DDB and regular bond.

Conclusion

Thus the tax changes proposed in the budget suggest significant changes in the investment, financing and dividend strategies of the corporate sector. The continuing reduction in the import duties is already putting enormous pressure on Indian companies to cut large chunks of costs to be able to compete effectively. The budget, by seeking to confer greater rewards for the efficient and perhaps, unintendedly increasing investor pressure for increased dividends, is giving a clear message to

company managements to undertake only productive and profitable investments. And to help them in this effort, there is also an attempt to reduce the industry's cost of capital. The budget thus offers strong incentives to company managements to create and capture shareholder value. Will the corporate sector get its act together? That is the big question.

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