Direct Tax in the Union Budget 2019: Two areas of Concern

Hon'ble Union Finance Minister had her task cut out when she was chosen to handle the finance portfolio. It was a tough task- she had to learn the art of budget making in a month's time. Therefore, one must give her credit for doing a reasonably good job. Two important and welcome announcements in the budget are: (a) tax benefit on affordable housing; and (b) tax incentive on electric vehicle.

Lots have been written on the Budget 2019. I wish to highlight on two issues which, though talked about, have not seen enough deliberations. *First*, lower rate of tax for companies with turnover up to Rs.400 crore; *second*, tax on share buyback by listed companies.

Corporate Tax: Implications for Labour Market

The maximum marginal rate of income tax for super-rich in India, having an annual total income above Rs. 5 crore (Rs.50 million), has been raised to 42.74% (*see Table* 1). If one compares the new effective rate in India with some other countries, one finds that there are countries with even higher rate of super-rich tax (e.g., in Germany it is 45%). Therefore, the super-rich in India should not complain. But citizens in Germany (both rich and poor) are well covered by public and private health care system at much affordable costs, which is not the case in India. However, I am not going to compare, in this piece, the marginal tax rates across countries and thereby justify or criticize imposition of super-rich tax.

Table 1: Super-rich Tax Rate in India

Description	Earlier	Now	Earlier	Now
For income above (Rs. Lakhs)	200	200	500	500
Tax rate	30%	30%	30%	30%
Surcharge	15%	25%	15%	37%
Health and Education Cess	4%	4%	4%	4%
Maximum Marginal Tax Rate	35.88%	39.00%	35.88%	42.74%

Note: Cess is levied on the sum of income tax and surcharge amount.

One needs to look at the new super-rich tax on salaried individuals and liberal corporate tax on domestic companies with an annual turnover up to Rs.400 crores (4 billion) together. How big is the super-rich pool in India? One source[1] mentioned that only 150,000 tax payers have declared annual income of over Rs. 1 crore (10 million) during 2018-19 (an increase of 69% over the past five years) and most of them are salaried individual. This amounts to 0.1% of the total population

1 Business Standard (February 8, 2019*). 1.2 bn Indians, but just 150,000 declared income of over Rs 1 crore: CBDT*

of 1.2 billion Indians. Contrast this with the number of Indian companies with an annual turnover of less than Rs. 400 crore. According to our Finance Minister, this is 99.3% of the total number of registered companies (about 800,000) in India. Thus, majority of the tax-paying companies would benefit from this generous corporate tax rate. Last year, the liberal tax rate of 25% was applicable for companies with annual turnover up to Rs. 250 crore. More number of companies are now brought within the lower tax net of 25%. The idea was to provide relief to small enterprises. But, does it really help? How much of the tax benefit has been ploughed back for asset or job creation?

The marginal tax rate for these small companies would come to about 29% inclusive of surcharge and health and education cess. Is it going to help the startups? Not really as majority of the startups are loss-making and hence do not pay corporate tax. Contrast this with the maximum marginal tax rate of 42.74% for a salaried individual whose annual income is just above Rs.5 crore. Will it not lead to tax arbitrage? A salaried employee, with an annual salary above Rs. 5 crore (or even Rs. 2crore) decides to resign from full-time employment and then joins the same company as a consultant for the same fee. Meanwhile, she forms a consulting company for this purpose. She will enjoy a tax benefit of close to 14% (42.74%-29%) on her total income. The company which engages her as a consultant will continue to enjoy usual tax benefit on the professional charges paid. Also, she may pass on a part of the arbitrage profit to the company (her previous employer) and lower her professional charges. The tax benefit to the new consultant would even be larger. While she was a salaried employee, she would pay tax on her total income (after usual deductions available under section 80C and others). Note that she would not enjoy additional tax benefit on house property as the property value should be less than Rs. 50 lakhs, which is very low for any super-rich employee. However, as a consultant company, she can deduct house rent, depreciation and other expenses from her income while estimating her tax liability (*see Table* 2). The effective tax can, therefore, be lower than 29%. In addition, a smart consultant would show most of the 'income' of the consultant as reimbursable expenses in the company's P&L and would reduce overall tax obligations for the consultant.

Table 2: Tax Liability: Employee Vs. Consultant

Super rich-employee	As employee	As consultant
Total income	550	550
Rent of self-occupied house	0	12
Depreciation on motor vehicle	0	0.75
Depreciation on computers	0	0.20
Maximum marginal tax rate	42.74%	29.12%
Tax payable	235.09	156.39

Note: Figures, except tax rate, are in Rs. Lakhs. It is assumed that the consultant is a one-person company (OPC). The tax payable is calculates using the maximum marginal tax rate.

Therefore, the lower tax rate may encourage companies to engage more consultants in place of full-time senior executives. The Companies Act (2013) requires companies to have full-time key

management persons (KMP). The corporate employer will definitely have those KPMs and engage other high-paying employees as consultants.

A report[2] shows that about 64 employees of Infosys have earned more than Rs.1 crore as compensation in the FY 2018. Though a part of the compensation is in the form ESOP (employee stock option plan), yet there are many out of the 64 employees who earn more than Rs. 2 crore salary per annum. Even ESOP is taxed at the time of exercise of the option. Similar high compensation is offered to top employees in many companies in India.

Therefore, the premium labour market (with per head annual salary above Rs. 2 crore) may witness a change in the compensation contracts in view of the difference in the corporate tax rate and the tax rate for the high net worth individuals. The tax arbitrage may prove to be beneficial for the companies in terms of lower labour costs should the individuals decide to pass on some part of the tax benefit to the employer. The individual employees may form a one person company (OPC), which is treated as a private limited company and hence would enjoy the lower corporate tax rate.

Critics say that an honest salaried tax payer is being 'punished' for her honesty.

Tax on Share Buyback

The Hon'ble Finance Minister has introduced a 20% distribution tax on share buyback by listed companies. Until now, such tax was applicable only to unlisted companies. It is claimed that with the introduction of buyback tax, the tax arbitrage (withholding tax on dividend and not on buyback) will end. Now investors will not be taxed on capital gains on buyback. Prior to the new rule, an investor could set off capital gain on buyback against capital losses- this benefit would go. The dividend distribution tax has been kept unaltered at an effective rate of 21.2%- the DDT has to be grossed up and now includes an increased cess of 4%. Therefore, the buyback tax would be almost at par with DDT. It was mentioned[3] that companies took advantage of the loophole in the tax laws and indulged in massive share buyback as a preferred route to return cash to shareholders as against cash dividend (*see Table 3*). There was indeed a huge spurt in both the number and value of share buybacks in India since 2016. In fact, 82% of the value of shares bought back in the past 18 years happened in the last three years. So, there seems to be some justification for the imposition of the new tax on share buyback.

Earlier, an average investor, whose annual income from dividend would not exceed Rs.1 million, would not pay any tax on her dividend income and pay only a capital gain tax of 10% on amount

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2 Business Today (May 21, 2019). *Infosys' Richie Rich club: Number of executives earning over Rs 1 crore increases to 64 in FY19, says report*

3 LiveMint (July 16, 2019). *Govt's new buyback tax set to hit MF investors, shareholders alike.*

received through share buyback via stock exchange. The recent changes in the tax laws do not affect that marginal investor. But it seriously affects mutual funds and large investors. Mutual fund investors are already at a disadvantage as they have to pay an additional 10% tax if they opt for funds paying dividend. Now with the imposition of tax on share buyback, cash flows to mutual funds would dry up and hence return on equity would fall.

Table 3: Share Buyback in India during 2000-2018

Share Buyback in India during 2000-2018		
Total Amount bought back (Rs. Crore)	140120	
Total number of buyback made	460	
Mode of Buyback (Number):		
Through stock exchange	254	
Through Tender Offer	206	
Year-wise break-up		
Year	Number	Value (Rs. Crore)
2000	15	1160.85
2001	19	504.45
2008	32	2167.18
2015	13	1263.15
2016	37	27887.44
2017	50	55273.77
2018	63	32385.25

Source: Prime database

Interestingly, the effective corporate tax rate for a dividend paying company in India is higher than those who hoard cash. Therefore, tax laws encourage companies to either hoard cash or re-invest in similar or diversified business. It may appear to be a sound tax incentive as it should spur investments. But we have seen in the recent past that companies have tendency to hoard cash. Way back in 2012, the top 5 non-finance companies in India had cash and cash equivalents of Rs. 165,486 crores. For example, Coal India limited had a cash holding of Rs. 58,202 crore in 2012 and the cash holding has drastically reduced to Rs. 4193 crore in March 2018- thanks largely to its massive buyback programmes.

Coal India was not alone- large corporations (including major public-sector companies) always used to hoard tons of cash and as a result the Government of India had to come out with a notification mandating every profit-making central public sector undertaking to distribute surplus cash to the shareholders (i.e, government) by way of dividend and share buyback. Similarly, there was constant pressure from the active shareholders (including mutual funds and pension funds) on the companies to distribute surplus cash and not diversify to unprofitable territories. Companies had responded to the pressure in the past by distributing a large part of the surplus

cash through tax-efficient buyback route. The massive buyback numbers (Table 3) since 2016 were signs of distribution of large cash holdings. Now that would be tax-inefficient and hence buyback tax would encourage companies to again hoard cash or in many cases invest in negative NPV projects.

Distribution of free cash through share buyback (via stock exchange) is nothing but paying all the cash dividend at one go- the market price of a share is nothing but sum of present value of future dividend. If a company does not have profitable business opportunities, it is optimal if the company returns the cash to the shareholders allowing them to invest such cash in positive NPV projects. That would spur economic growth and hence yield better tax revenue for the exchequer in the long run. On the contrary, tax on cash distribution by way of share buyback would, at least in the short run, result in cash hoarding which earns sub-optimal return. This would lower future corporate tax revenue. In order to encourage payment of cash dividend, an alternative could be to tax share buyback if the dividend payout is less than average of previous five (or three) years' payout. The usual applicable capital gains tax in the hands of the recipients should continue.

Therefore, I suggest that cash distribution through share buyback should not be subject to the 20% distribution tax if a company has at least maintained the five-year average dividend payout. This way, companies would not be encouraged to hoard cash, dividend paying mutual funds would get enough returns from the portfolio companies and distribute healthy dividend to investors, pension funds which invest a part of their corpus in mutual funds would not face liquidity shortfall, and more importantly, large investors would have enough liquidity to invest in profitable business opportunities.