

Direct tax code- Glimpses of its impact on the Energy Sector

By Ganesh Raj

When archaic rules have to be replaced with new ones, the changes have to be dramatic and path breaking. The Direct Tax Code (DTC) endeavours to usher in an era of transparency and greater tax compliance. It signals a paradigm shift in the direct tax regime for the Indian economy and is touted as a replacement for the Income tax (I-T) Act, 1961, that would promote entrepreneurship, wherein the thrust would be on 'regulated free markets.'

The complexity of the current Indian tax system is enormous. For several years, the numerous interwoven sections, sub-sections, clauses, sub-clauses, cross references, explanations, provisos, etc. have been the focus of discussions of various tax administrators, chartered accountants, tax counsels, and even tax payers. The amendments carried out from time to time through annual fiscal budgets and the multiple judgements (which are often contradictory) further add to the complexity.

The DTC is regarded as an attempt to completely revamp the direct tax system in India. It is seen as a way for promoting efficiency and equity in India's tax system, while providing a stable source of revenues to fund government expenditures. However, the Code has garnered mixed reactions to its various proposals as while the objective of bringing equity may favor some interest groups, it may seem to be prejudicial to others.

From the perspective of the energy sector, the DTC aims to provide a plethora of reforms, the impact of which has been analysed hereunder.

Impact on the Energy Sector

The energy sector, which primarily includes oil, gas and power companies, has been universally recognized as one of the most important sectors for economic growth and human development.

Recognizing the imponderable risks, especially which the power sector entails, with long gestation periods, high costs, and budget constraints, the Government has, time and again, provided incentives in the form of tax holidays (for a period of 10 years out of an initial block of 15 years) to the companies engaged in this sector. In return, it is considered that these incentives ensure investment flow, lower cost of development, and consequently lower user charges for the common man.

For the oil & gas sector, the Government has provided a tax holiday for a period of seven years from the commencement of commercial production to the oil and gas exploration and production (E&P) players. However, since significant expenditure is done in the exploration and development phase and the initial production is low, the E&P players are unable to effectively utilize the tax holiday.

Investment-based incentives vs. Profit-based incentives

Traditionally, the exemptions, in the form of tax holidays, envisaged in the I-T Act were 'profit-based' for a certain number of years and available to key infrastructure companies, including power, oil and gas. Such incentives have therefore been regarded as inefficient and regressive as they possess an inherent risk of shifting the profits to the exempted activity. As a result, there is no incentive for investment and upgradation during the period of the tax holiday and the entire focus of all business activities shifts to earning of profits.

In contrast, the major change brought in by the DTC relates to rationalising of tax exemptions. The Code provides for the grandfathering of profit-linked tax incentives which implies that taxpayers engaged in the energy sector would continue to be eligible for tax deduction for the unexpired period of the tax holiday.

Further, the DTC proposes to replace the profit-based incentive by 'investment-based' incentive. Accordingly, incentive schemes under section 80-IA for power companies and 80 IB (9) for E&P companies will be discontinued. Under the proposed scheme, an entity would be allowed to recoup all its capital and revenue expenditure in the initial years of establishment and would be liable to pay income tax on profits made thereafter. This would result in deferring the tax liability till the recovery of investment cost and the recovery period denote the tax holiday period.

The purpose of replacing the tax incentive scheme from being profit-linked to investment-linked is to ensure shift of investment from proposals generating quick profits to capital intensive investments that take time to develop profits and therefore, it is held, there should be an incentive for investment.

However, for both power and the oil & gas sector, there may be a negative impact because of the proposed change. Typically, in the power sector, capital investment may be recovered in around 8 years, depending on various factors. Hence, technically, the tax incentive will be available to power companies only for a limited period, whereas, under the current legislation, such companies enjoy a tax holiday of 10 years. Further, E&P companies, under current legislation, are allowed to claim a significant part of their capital expenditure as deduction. Hence, allowability of capital expenditure in place of a tax holiday may not be advantageous for E&P players.

Gross Assets Tax Vs. Minimum Alternate Tax

Another significant change which would impact all capital intensive industries, including the energy sector which has a large asset base, is the newly introduced Gross Assets Tax (GAT). GAT is proposed to replace the existing regime of Minimum Alternate Tax (MAT) for companies. The discussion paper to the DTC outlines a minimum alternative tax theory to ensure that a minimum tax collection is warranted to bridge the gap between the normal tax rate and the effective tax rate on incomes of companies which may be very low on account of various tax incentives carved out under the I-T Act.

Under the existing regime, MAT is levied on the book profits of a company in a year where the normal tax liability of a company is less than 15% (proposed to be increased to 18%) of book profits and is eligible for credit against normal tax liability for 10 consecutive subsequent years. Under the DTC, GAT is proposed to be charged at the rate of 2% of gross assets, which includes capital work-in-progress. It is also proposed that GAT will be the final tax and will not be available as tax credit in subsequent years.

Apparently, this new alternative tax regime has been introduced by the Government to curb tax evasion by underreporting of book profits and on the premise that investors are expected to earn a specified average rate of return on their assets, which should be charged to tax. GAT presumes that a company is expected to earn a minimum return of 8% on its assets assuming a corporate tax rate of 25%.

Since the GAT regime does not provide any gestation period / start up exemption, newly set up businesses will have higher burdens vis-a-vis old businesses which are up and running and comparatively have depreciated asset bases. The proposed GAT, in its present form, could cause high tax costs for companies in the energy sector, which have long gestation periods and high capital and asset bases and could discourage capital investment in this sector. Further, if investment linked incentives are provided to this sector in the initial years, there will be no tax liability, under the normal provisions, till such time the investment cost is recovered. However, such sectors will be subject to GAT on such investments. Thus, the application of GAT would also work against the 'Investment linked incentive.' Under the GAT regime, since there is no close correlation between the tax levied with a particular year's income, every company will have to pay tax regardless of whether there is any real income.

This is likely to adversely impact new power and E&P units, since in the initial years these units typically have huge capital works-in-progress.

Presumptive taxation

For the service providers to the upstream oil & gas sector, similar to the I-T Act, the DTC seeks to provide presumptive taxation wherein the prescribed deemed profit is 10 per cent. However, the DTC seeks to provide that the presumptive taxation can be increased if the actual income earned by the taxpayer is higher than the specified percentage. This seems to be against the spirit of the scheme of presumptive taxation.

Ring-Fencing

In another proposal relating to tax incentives, it is proposed to ring-fence the profits / loss of specified businesses eligible for tax incentives by providing a specific method for computing the profits / losses of such eligible businesses.

Owing to this provision, even loss on account of normal business expenditure and normal depreciation of the E&P business or power generation or distribution business cannot be offset against profits from other businesses. Such provision shall benefit only those tax payers who have an existing specified profitable business and can afford to make further investment. However, the provision does not favour tax payers, who are engaged in other businesses, or completely new entrants who have nil or negligible profits in the initial years of operation.

Similarly, the incentive does not work if new investment is carried out through investing in a Special Purpose Vehicle (SPV) and the SPV is not able to derive benefit in the initial years. Consequently, the company, which otherwise would have paid much lower taxes on account of set off of losses of incentivised business from other businesses, may end up paying higher taxes.

Taxation of foreign collaborators of energy sector projects

The code proposes to increase the tax rates on royalties / 'fee for technical services,' earned by foreign companies for providing technical support to Indian entities, from 10% to 20%. The proposal of increasing the tax rates on such income streams seems to be unsupported, particularly when the trend is to liberalize the tax rates. Since most of the capital exporting countries provide for foreign tax credit on foreign sourced income, increase in the tax rates in India would in turn mean that such incremental revenue to India would be funded by foreign governments. Thus, the change could cause considerable increase in costs of energy sector projects, where foreign collaborators are rendering technical services, especially under net of tax arrangements.

Further, the DTC proposes to change the residency test for a foreign company so that a foreign company, having even partial control and management in India, would, it is proposed, be considered as resident in India. This could materially change taxation of foreign companies having presence in India, since, worldwide the income of a resident company is liable to be taxed in India. Companies in the energy sector often collaborate with their foreign counterparts to execute their projects in the area of Engineering, Procurement and Construction (EPC) contracts in India.

The DTC proposes to levy a 15% Branch Profits Tax (BPT) on post-tax profits of the branch of a foreign company. Effectively, BPT would counterbalance reduction in the corporate tax rate from the present 40% to 25% (as proposed under DTC) for a foreign company, keeping the effective tax cost for a foreign company almost the same. However, the term 'branch' has not been defined in the DTC, which could lead to ambiguity and different interpretations. On account of BPT, the tax rate for foreign companies executing projects through branch / project offices could result in an effective tax rate of 36.25% instead of the reduced corporate tax rate of 25%, as proposed for other companies in the DTC.

Conclusion



In view of the above discussion, it can be said that, though the proposed DTC is a well intended tax reform, which could change the way taxes are being perceived in the country, it still needs to be seen how the provisions shall be enforced so as to align the interests of the Government and the stakeholders. Lowering of the corporate tax rate will definitely be a move towards bringing the Indian tax environment closer to international benchmarks. At the same time, if the revenue loss is recouped through the application of inflexible taxes, like the gross asset tax or through a complete phase out of tax holidays, the same could introduce economic distortions.

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