

Decoding the Direct Tax Code - MAT – Making Companies slim Ms. Kareena Kapoor style

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Introduction:

- 1.0 The objective of new Direct Tax Code (DTC) as stated in the Discussion Paper (DP) published are broadening the base, minimize exemptions, horizontal and vertical equity etc. Since the proposed DTC touches all the aspects of taxation of income of all the types of the assesseees, it will be interesting to see to what extent these objectives will be achieved. However, in respect of the provisions of Minimum Alternative Tax (MAT) one can certainly say that apart from raising additional revenues, the proposed provisions in this respect will make large number of corporate houses active, re-design the business plan, make better use of the resources available and reduce the obesity from the asset side of the Balance Sheet (BS). An attempt has been made here to examine these provisions from various perspectives, advantages which it can deliver to the Indian economy at large, laden the companies with large infrastructure projects with a new burden of funds outflow from the day-one, discourage certain practices followed by the corporate houses to avail depreciation benefit and other incentives etc.

Justification for MAT:

- 2.0 Ever since the introduction of MAT, there has been consistent demand from various sectors for its removal. Each sector has its own reason to justify it. However, the Government was determined to continue with it. Looking to the proposed provisions in DTC, it appears that the thinking at all the levels in the Government is very clear i.e. there is a strong case for continuing with MAT. Read the following paragraph of the DP, which justifies the existence of MAT. It clearly shows how determined is the Ministry of Finance in this respect.

A company would ordinarily be liable to tax in respect of its total income. However, owing to tax incentives and tax evasion, the liability on total income, in many cases, has been found to be extremely low or even zero. Therefore, internationally, a variety of economic bases and methods are used to calculate presumptive income so as to overcome the problems of tax incentives and tax evasion. For example, certain presumptions are based exclusively on the taxpayers' net wealth or on the value of the assets used in his business. Other presumptions are based on the gross receipts of the enterprise; some others are based on visible signs of wealth. Standard assessment methods use several key factors and indices of profitability, which vary according to the activity, to determine the taxpayer's income.

Methodology for levying MAT

- 3.0 So far the model adopted in this respect was based on book-profit. However, there is a marked shift in this respect as it is proposed to levy tax on the value of gross assets. While this will certainly achieve the objective of charging tax from the companies not paying the tax at all but it will also penalize the companies which are sloth. Certainly, clause 2(3) of DTC is hitting two birds with a single stone. See how the DP deals with this aspect of the issue.

Several countries have adopted minimum taxes based on a fixed percentage of the assets of a business. The economic rationale for the assets tax is that investors can expect ex-ante to earn a specified average rate of return on their assets. Therefore, it provides an incentive for efficiency. Accordingly, the Code provides for Minimum Alternate Tax calculated with reference to the “value of the gross assets”. The shift in the MAT base from book profits to gross assets will encourage optimal utilization of the assets and thereby increase efficiency

Methodology for computing Gross Assets (GA)

- 4.0 The DP narrates the methodology to be followed for arriving at the value of GA as under.

“Value of gross assets” will be the aggregate of the value of gross block of fixed assets of the company, the value of capital works in progress of the company, the book value of all other assets of the company, as on the last day of the relevant financial year, as reduced by the accumulated depreciation on the value of the gross block of the fixed assets and the debit balance of the profit and loss account if included in the book value of other assets.

The rate of MAT will be 0.25 per cent of the value of gross assets in the case of banking companies and 2 per cent of the value of gross assets in the case of all other companies.

Under the Code, MAT will be a final tax. Hence, it will not be allowed to be carried forward for claiming tax credit in subsequent years.

Though it seems very simple, as we shall see in detail, it is having far reaching implications.

The First Step

- 5.0 Let us understand the provisions through which MAT is proposed to be levied.
- 5.1 Clause 2(1) of the DTC provides for levy of IT on every person on his total income of the Financial Year (FY).
- 5.2 Clause 2(2) provides for the methodology to be adopted for computation of the tax liability. It is provided that the tax shall be calculated at the rate specified in the First Schedule and in the manner provided therein. The First Schedule provides for rate of tax for different types of entities. It also provides for rate of tax in the case of companies @ 25.00%.
- 5.3 Clause 2(3) provides for an exception in the case of the companies. It is provided that tax liability in the case of a company will be higher of the amount as calculated as per the First Schedule i.e. @ 25.00% or @ 2.00% of the value of GA. The provision in this respect reads as follow:

(2) The liability to pay income-tax, referred to in sub-section (1), shall be the amount of income tax calculated at the rate specified in the First Schedule and in the manner provided therein.

- (3) However, if a person is a company, the liability to pay income-tax referred to in sub-section (1) shall be the higher of the following amounts:
- (a) the amount of the liability calculated under sub-section (2); and
 - (b) the amount calculated at the rate specified in Paragraph A of the Second Schedule and in the manner provided therein.

How to compute tax liability?

- 6.0 In view of this, in order to arrive at the tax liability, all the companies will have to make two types of computation as follow:
- (a) Compute the taxable income as provided under section 58 to 64 of the DTC
 - (b) Apply the rate of tax i.e. 25.00% on it
 - (c) Compute the value of GA as laid down in Paragraph A of The Second Schedule
 - (d) Apply the rate of 2.00% on it
 - (e) Compare the result as arrived in (b) with (d)
 - (f) Final tax liability will be higher of (b) or (d).

- 6.1 One may be under an impression that by paying the tax at the rate of 25.00%, the question of MAT will not arise. However, under the proposed scheme, the whole scenario will get changed. This is for the reason that the tax liability as computed by applying the rate of 25.00% need not be commensurate with 2.00% of the value of GA. This can happen in the case when the company is not making efficient use of the resources at its command, meaning thereby taxable income generated is not sufficient enough as compared to assets it possesses.

Methodology for computing Gross Assets (GA)

- 7.0 Paragraph A of the second Schedule provides for the methodology for computation of GA. It reads as follow.

97. (1) *The value of gross assets referred to in Paragraph A of The Second Schedule shall, subject to the provisions of this Chapter, be computed in accordance with the formula $A + B + C - D - E$*

Where A = the value of the gross block of fixed assets of the company as on the close of the financial year;

B = the value of the capital work in progress of the company as on the close of the financial year;

C = the book value of all other assets of the company as on the close of the financial year;

D = the accumulated depreciation on the value of the gross block of fixed assets, claimed up to the last day of the relevant financial year;

E = the amount of debit balance of profit and loss account, if included in the amount 'C'.

As can be seen it covers all the assets as appearing on the asset side of the Balance Sheet.

Recasting of the Balance Sheet?

- 8.0 Generally, annual accounts as approved by the shareholders are the basis for computation of tax liability. However, some companies have, in the past, tried to circumvent the provisions in this regard by preparing two sets of annual accounts, one for computation of MAT and the other for the shareholders. Having burnt the fingers once, the Government is cautious have specifically laid down that the value of GA be computed on the basis of Balance Sheet as prepared as required under the provisions Part I of Schedule VI of the Companies Act. Read the following paragraph.

98. (1) Every company shall, for the purposes of section 97, prepare his balance sheet for the relevant financial year in accordance with the provisions of Part I of Schedule VI to the Companies Act, 1956.

(2) The company shall, for the purposes of preparing the balance sheet referred to in sub-section (1), adopt the same accounting policies, the accounting standards adopted for preparing its accounts including profit and loss account and the method and rates adopted for calculating the depreciation as have been adopted for the purpose of preparing the accounts

(a) laid by the company at its annual general meeting in accordance with the provisions of section 210 of the Companies Act, 1956; or

(b) delivered to the Registrar under section 594 of the Companies Act, 1956.

(3) The company shall, in a case where the financial year adopted under the Companies Act, 1956 is different from the financial year under this Code, adopt the same accounting policies, the accounting standards adopted for preparing its accounts including profit and loss account and the method and rates adopted for calculating the depreciation as have been adopted for preparing the accounts for such financial year or part of such financial year falling within the relevant financial year.

(4) Every other person, in respect of whom the foregoing provisions of this section does not apply, shall also prepare its balance sheet and profit and loss account as if the foregoing provisions of this section apply.

(5) The Board may prescribe such rules, as may be necessary, to modify the provisions of sub-sections (1) to (3) for the purposes of enabling the preparation of the balance sheet and profit and loss account under sub-section (4).

- 8.1 Sub-clause (3) takes care of the companies having calendar year as their accounting year or some other period. In such cases, these companies will have to prepare the BS as on 31st March of each year. Not only that these companies will have to follow the same Accounting Standards (AS) and Policies as have been followed for the Companies Act.

A Barometer for Efficiency?

- 9.0 As per the proposal, rate of tax i.e. 25.00% is required to be compared with 2.00% of value of GA. It means that total taxable income of the company should be 8.00% of the value of GA. For example, if the totals GA of a company are at Rs. 100 then its

total taxable income for the year should be at least Rs. 8.00. When we apply the rate of tax of 25.00% on Rs. 8, we get the figure of Rs. 2.00 i.e. 2.00% of Rs. 100. Meaning thereby, if the total of the asset side of the BS is Rs. 100 cr. then its total taxable income should be at least Rs. 8.00 cr. Anything less than that will require it to pay the tax for which it has not earned at all. For example, in this case, if the total taxable income is Rs. 6.00 cr. then it will be paying tax of Rs. 50 lacs (i.e. 2% of Rs. 100 cr. i.e. Rs. 2.00 cr. less: 1.50 cr. 25% of Rs 6.00 cr.) which will be reflecting its inefficiency. This is bound to hit hard to large number of companies as it will be difficult to reconcile to the fact of paying income tax for not earning the income. Put it in a different way, it will be taxing the notional income. To what extent it can be justified, and its long term impact on the Indian economy, is a complex issue requiring detailed examination of various factors.

Nature of tax paid @ 2.00%

- 10.0 Read the provisions of sub-section 3(a) and (b) carefully. It provides for methodology for computing tax liability. Generally, tax liability is attached to taxable income at a pre-determined rate of tax. However, here it is linked to value of assets as well. Secondly, the DTC nowhere refers to it as MAT. It should be remembered that the amount of MAT paid has not been labeled as such differently as it has been done u/s 115JB of I Tax at present. In fact, the term MAT has not been used in DTC at all. (See S 284 which defines various terms used in the DTC). Provisions of MAT have been structured in such a way that it looks like the company is paying the income tax in normal course. Two things emerges viz. no credit to be expected in future for having discharged the tax liability for any year in the past. Secondly, each year being separate, the same process has to be carried on and pay the tax accordingly.

Consequential Impact

- 11.0 Generally, when a company starts incurring losses, no tax is being paid as advance as there will not be any tax liability. However, in view of the provisions of clause 3(b) will be that all the companies will have to compute advance tax liability for at least 2.00% of the GA as on 31st March of the last FY. This is for the reason that generally, barring unforeseen circumstances, total assets of the company will increase or remain as they are. An offshoot of this will be that even if the company is making losses from 1st of April of the FY, and availability of the liquid funds or not, it will have to pay advance tax on 15th June, 15th September, 15th December and 15th March. Not only that the total amount of advance tax so paid should be equal to 2.00% of GA. Its failure to do so will lead to payment of interest for default in payment of advance tax.

Who gets affected?

- 12.0 Under the existing MAT provisions, its applicability is restricted to the companies showing profit in their books of account and tax payable thereon being less than 10.00% of such profit. It mainly covers the cases wherein depreciation claim under the I Tax Act being much higher than under the Companies Act, the companies coming out of loss making period and having unabsorbed loss / depreciation or the companies having substantial amount of exempt income. In such cases, it is possible for these companies to declare dividend out of current year profit. The justification for levying MAT being, if the Company can pay dividend to its shareholders, there is no reason why it should not pay at least some amount of tax to the Government. In view of this, computation of MAT was linked to book profit and tax liability. However, as appears from DTC, there is a marked shift in the thinking in the Government in this

respect. Although the objective of levying tax on all the companies earning still remains, it widens its scope substantially. By linking the rate of tax with value of GA, the Government is conveying a clear message that efficient usage of the resources available is equally important. If the company is not in a position to use the resources at certain bench-mark laid down, it should be penalized in the form of levying tax and transferring such idle resources to the exchequer. Let us try to see which types of cases will get affected by the proposed provisions.

- a) Companies which have made losses in the current year
- b) Companies having made profit but not sufficient enough to absorb the depreciation available under the DTC
- c) Companies having low ratio of Sales to GA and also having low margin on sales
- d) Companies having low ratio of Sales to GA and having high ratio of margin on sales but not sufficient enough to reach to the level of 8.00% of the value of GA
- e) Companies deriving substantial amount of its income from sources which are exempt, say, dividend
- f) Companies which are in the process of setting-up the project

Each of these cases requires a detailed diagnostic and applicable remedy to avoid MAT. Let us examine each case individually and see why, how and to what extent MAT will affect them.

Companies which have made losses in the current year

- 12.1 This is the obvious case as there will be no taxable income for the company having made the losses. Tax liability as computed under 3(a) will be Nil. However, the company will be having some assets, if not fixed assets, at least, current assets. Here, clause 3(b) will apply and tax will have to be paid @2.00%. It should be noted that the right to carry forward the loss will continue for an infinite period. In view of this, the companies making losses will get a hit as making loss results into outflow of liquid resources. As if this was not enough, tax liability of 2.00% of GA will have to be borne.

Companies having unabsorbed depreciation

- 12.2 In the case of manufacturing companies, in the initial phase, as it generally happens, volume of operations is not large enough to absorb the entire amount of depreciation benefit available, resulting into low taxable income. It also so happens that the manufacturing operations commence in the month of say, February or March i.e. at the end of the year. In such cases, also depreciation claim available under DTC will be substantially more than the profit derived from the operations of two or three months. Such cases will also get trapped into the clutch of clause 3(b).

Companies recovering from loss period

- 12.3 The worst case will be that of the companies which have made losses in the past and are recovering by making some profit during the current year. In this case, the company having the right to set-off the carried forward losses and depreciation may not have sufficient taxable income to absorb it. Thus, in the case of the companies making losses it will get affected not only in the year in which it makes losses but the

subsequent period of recovery as well. It will remain so till they reach the level of having taxable income of 8.00% of GA.

Companies having low ratio of Sales to GA

- 12.4 For various reasons, it may not be possible for the company to have high ratio of Sales to GA resulting into low level of taxable income. In such cases, the company need not necessarily pay the tax at lower rate of 25.00%. However, it may be less than 8.00% of value of GA. In view of the assets being utilised at very low level, clause 3(b) will get invoked. The problem may get accentuated when the ratio of net profit and sales is also low. This will have cumulative impact. Its quantitative impact and break-even point can be seen from the Table given in para 13.0.

Companies having low ratio of NP to Sales Ratio

- 12.5 This is the obvious case of invoking the provisions of clause 3(b). Low NP: Sale ratio is bound to give low volume of taxable income which may not be sufficient enough to match with the criteria of 8.00% of value of GA. These are the cases wherein the turnover is high but value addition is substantially lower.

Companies having substantial amount of exempt income

- 12.6 At times, corporate entity is being used for the purpose of holding certain immovable and moveable assets. For example, substantial amount of shares of the parent and Group companies are held through private limited companies. In such cases, income derived will be from dividend which is exempt. In view of this, taxable income will be lower as income from dividend will not be forming part of it. This may invoke the provisions of 3(b). In the case of immovable properties, rental income derived may not be high enough to match with the 8.00% of value of GA. (Incidentally, in the case of computation of income from house property, S 25(3) of DTC provides for 6.00% of cost of construction as presumptive rent from such properties). Therefore, all the companies not having any major business activities but are holding the assets only will face a problem.

Companies in the process of setting-up the project

- 12.7 This will be the worst case to be affected by clause 3(b). In the case of large manufacturing units, it takes more than one year to set-up the project. During the intervening period, there will be no major business activities leading to no income. At the most, such companies place their surplus funds in fixed deposit with the bank and derive income from interest. In view of the decision of the Supreme Court in the case of Tuticorin Alkalies [1997] 93 TAXMAN 502 (SC), the I Tax Department is treating it as income from other sources and levying the tax accordingly. In view of specific reference to Capital Work-in-Progress in the method of computation of value of GA, all the plants and machineries which have not been put to use will also get covered herein. The promoters, therefore, depending on the time factor to implement the project, will have to built-in this factor of outflow of funds on account of payment of tax while projecting total financial requirements.

How much fast should one run?

- 13.0 No one likes to throw away money without getting any consideration and that too, paying tax without earning anything is out of question. This is for the reason that if no care is taken, the capital base may get eroded in the long run, affecting substantially the very existence of the company. But the moot question is how to determine

obesity? How much should one run fast? The Table below will give some idea about it.

	Gross Asset Rs.	100			
	Rate of Tax on Income	25.00%			
	Rate of Tax on GA	2.00%			
	Sales:GA	Taxable Income: Sales (%)	TI	Tax	MAT
	A	B	C	D	E
1	1.00	7.00%	7.00	1.75	2.00
2		8.00%	8.00	2.00	2.00
3		9.00%	9.00	2.25	2.00
5	1.25	6.00%	7.50	1.88	2.00
6		6.40%	8.00	2.00	2.00
7		7.00%	8.75	2.19	2.00
9	1.50	5.00%	7.50	1.88	2.00
10		5.30%	7.95	1.99	2.00
11		6.00%	9.00	2.25	2.00
13	1.60	4.50%	7.20	1.80	2.00
15		5.00%	8.00	2.00	2.00
16		6.00%	9.60	2.40	2.00
17	1.75	4.00%	7.00	1.75	2.00
18		4.58%	8.02	2.00	2.00
19		5.00%	8.75	2.19	2.00
21	2.00	3.75%	7.50	1.88	2.00
22		4.00%	8.00	2.00	2.00
23		4.50%	9.00	2.25	2.00
25	2.25	3.00%	6.75	1.69	2.00
26		3.55%	7.99	2.00	2.00
27		4.00%	9.00	2.25	2.00
29	2.50	3.00%	7.50	1.88	2.00
30		3.20%	8.00	2.00	2.00
31		3.50%	8.75	2.19	2.00
33	2.75	2.75%	7.56	1.89	2.00
34		2.90%	7.98	1.99	2.00
35		3.00%	8.25	2.06	2.00
37	3.00	2.50%	7.50	1.88	2.00
38		2.66%	7.98	2.00	2.00
39		3.00%	9.00	2.25	2.00

13.1 Column A represents relation between sales and GA. For example, row 5 represents 1.25 meaning thereby sales for the whole year is Rs. 125 with the GA of Rs. 100. It means how many times GAs are rotated. Higher the ratio better it is, for it represents effective use of the resources. There cannot be any standard for it, as it depends upon facts of each industry, level of mechanization of the production process, terms of trade viz. credit period offered etc.

- 13.2 Column B represents ratio of Taxable Income (TI) to Sales. It is derived by dividing Total Taxable Income by the amount of Sales. It is a relative term and is represented in terms of percentage.
- 13.3 Column C represents Taxable Income. This is derived by applying the figure in column B to A. Here it is presumed that depreciation under the Companies Act and DTC are same.
- 13.4 Column D represents the amount of tax payable i.e. applying the rate of tax of 25.00% to the figure in column C. This is what is referred to in clause 2(3)(a) of DTC.
- 13.5 Column E represents tax liability computed by applying the rate of 2.00%. Since for the cases it has been taken at Rs. 100, it is Rs. 2.00.
- 13.6 In terms of the provisions of clause 3 of DTC, the final tax liability will be higher of the amount appearing under the column D or E.
- 13.7 Figures appearing in bold and highlighted represents break-even point i.e. the stage at which under a particular stage of Sales:GA, MAT will cease to apply. Difference between D and E will represent tax on not earning sufficiently. It can be called a tax on inefficiency.

Remedial Measures

- 14.0 It will be difficult for any one to digest the fact of paying tax for not earning. Naturally a question will arise what are the alternatives available? One alternative is to increase the taxable income by having more profit. This can be achieved by charging more for the product / services. In these days of fierce competition it is out of question, as any attempt to do so may raise the very question of survival. Another option will be to reduce unproductive expenditure i.e. expenses with low value addition. Third alternative is to have higher asset turnover ratio i.e. having more production with the same set of resources. Ideal solution will lie in a mixture of all the three. The companies will have to reassess its area and capacity of strength and re-focus its activities.

Paradigm Shift in Approach

- 15.0 Today, in the case of most of the companies, volume of activities with respect to acquisition of machineries and other assets gathers momentum in the month of January and reaches momentum in the last week of March. This is mainly to avail the benefit of depreciation for six months which helps in bringing down the tax liability. However, with the proposed scheme of taxation, for the following reasons, the traditional approach will not work.
- 15.1 Firstly, any acquisition of assets will lead to higher amount of GA. This will, in turn, raise the amount of tax payable at 2.00%.
- 15.2 Secondly, with the acquisition of new asset depreciation will be permitted for six months (See Note No. 3 of the Fifteenth Schedule of DTC) reducing the amount of taxable income substantially. Thus, any acquisition of assets, particularly in the last three months of the year, will lead to applicability of MAT. If the asset is acquired

from the internal resources, there may be one dimensional impact only, as there will not be any addition to GA. This is for the reason that bank balance will get converted into some other form of asset.

- 15.3 The problem will become more severe if the asset is acquired with borrowed funds. It should be remembered that there is no provision for deduction of liability from GA. Therefore, in such cases there will be addition to GA without any corresponding addition to taxable income. Thus, as explained above, there will be impact from both the dimensions viz. low taxable income due to depreciation on new assets and incremental level of GA .
- 15.4 At times, the companies are required to accommodate their bankers at the end of the year by placing substantial amount of borrowing made for working capital (i.e. Cash Credit Hypothecation etc.) to Fixed Deposit for a short term. (This practice is quite prevalent in the banking industry and is popularly known as “window dressing” as it helps them by having inflated figures of both the deposits and advances.) Any indulgence into such practices will hit the company as any accommodation to the banker of Rs. 100 will entail loss in the form of payment of MAT of Rs. 2.00. For example, any accommodation of, say, Rs. 1.00 cr. will straight way add to additional liability of Rs. 2 lacs. It should be remembered that interest derived, if any, will be in the next year as generally such transactions are entered in to at the fag end of the year.

Conclusion

- 15.5 The way in which DTC approaches the problem in this respect, one thing is clear that MAT has become a part of life and all of us will have to live with it. There is no point in living in imaginary world and expecting its removal. At the most, there may be some change in the methodology, some exceptions may be provided or the rate of tax be brought down from 2.00%. In any case, every one will have to sit down and draw new business plan, redesign the trade practices and shed the flab. Ms. Kareena Kapoor made herself famous and glamorous by becoming slim and achieving the zero figure fat in **“Jab We Met”**. Mr. Pranab Mukherjee proposes the corporate sector to be slim and beautiful through MAT. To what extent MAT will be able to burn the fat and make the sloth run, is a moot point to be seen.