MAT-A Case for Elimination

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< EXECUTIVE SUMMARY >

◆ Minimum Alternate Tax (MAT), in the layman's point of view, is the minimum amount of tax that a company has to pay, even if it is not liable to pay any tax as per the normal tax computation.

In this article author has argued that application of MAT on profitable companies results in a higher tax outflow than what would have been payable under normal computation and as a result the retained earnings available for investment activities goes down.

Author has also stated, while arguing for abolition of MAT, that the so-called zero tax companies (who have to pay MAT) are amongst the largest contributors to the national exchequer by way of custom duty, excise and sales tax etc, and these companies are not following any fraudulent tax practices but are only planning that tax liability in a legal and healthy manner, using the incentives which are existing in the rule book.

MAT or "Minimum Alternate Tax" has been a topic of intense discussion amongst tax payers as well as tax authorities all over the world. While a majority of the countries world over have refrained from levying such a tax, there are instances of countries like the United States, India, Mexico and Colombia among others who have introduced varying forms of MAT at one point or the other.

Why a "Minimum Tax"?

When looked at from a layman's point of view, and on preliminary thoughts, the principle of application of such a tax seems to be a very reasonable, social and fair principle. This is because the basic theme or logic of having such a tax seems very appealing to people who often wonder why they have to pay a large proportion of their hard earned money towards taxes while many large companies who earn millions do not pay any income tax at all!

It is this apparent inconsistency which has been bothering the minds of people across the world in the six years upto 2000. General Motors paid nothing in federal income taxes despite earning $22.4 billion in pretax US profits. Ford Motor Co. in the United States which earned $9.4 billion in pretax profits in 2000, paid only 6.3% of that in federal income tax, at a time when the corporate tax rate was about 35%.

There were many more similar instances e.g. in the cases of companies like General Electric, United Airlines etc. The idea that companies generating billions of dollars in profits and paying huge dividends actually pay negligible amounts of taxes appeared to be illogical and thus the concept of charging a "Minimum tax" (Alternate Minimum Tax or AMT) was born.

The phenomenon of flourishing companies paying little or no tax was not unique to United States alone. Even in India, some of the biggest names in Indian

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industry were replicating the same model. In some instances, the earnings of these companies would be even more than the gross revenues of some of the states but the total direct tax paid by them amounted to zero. This prompted the Indian Government to take note of the matter and in 1983, the concept of a minimum tax was introduced under section 80VVA of the Income Tax Act 1961. Modified versions of this section were introduced later on as section 115J, 115JA and 115JB. These amendments were meant to streamline and fine tune the MAT provisions based on prevailing circumstances.

Minimum Alternate Tax - Basic concept

MAT as the name implies is the minimum amount of tax which a company has to pay, even if it is not liable to pay any tax on its normal computation. Assessees have to calculate their taxes as per the regular method as well as per the procedure laid down for MAT computation, and pay the tax which is higher of the two. Under the regular computation, the person is entitled to all the deductions, exemptions and incentives available under the provisions of the tax code, such as accelerated depreciation, investment allowance, rebate for setting up industries in a backward area etc. The resultant computed income, therefore, normally would be much lower than the book profits. However, for the computation of income for the purposes of MAT, there are very few adjustments, if any, to be made to the book profits. Most importantly, the method of depreciation followed for the purpose of accounts is different from that considered for taxation purposes. As a result, MAT ensures that every profitable company would have to pay some tax every year.

Critique

Prima-facie, it would appear that the introduction of MAT is a very logical step to ensure that companies that otherwise would avoid paying their "fair share" of taxes, also end up paying some amount of tax on income.

However, if studied in great detail, Minimum Alternate Tax has some very far reaching implications. Economists all over the world have been debating on the efficacy of levying such type of a minimum tax. This is because MAT has the effect of reducing investment spending in several ways. Application of MAT on profitable companies results in a higher tax outflow than what would have been payable under normal computation and as a result the retained earnings available for investment activities goes down. The cash flow constraint becomes more relevant for companies at times when the capital markets are not doing well and the access to capital becomes tougher.

Apart from putting a strain on regular cash flows, MAT also discourages capital spending by raising the cost of capital or the base financial parameter which a project must meet before deciding to go ahead on the same.

The tax rate under MAT is much lower than the rate applicable under normal computation. This may sound very logical but it needs to be remembered that MAT is applied to a much more broader base. Consequently MAT frequently results in higher overall tax collection. To worsen the matters further, at least in the Indian context, the government has also withdrawn the carry forward and setoff of MAT credits against tax payments of subsequent years.

A key logic behind introduction of Minimum Alternate Tax was that hugely profitable companies paying substantial dividends must also contribute something by way of taxes. However, this logic does not necessarily hold true in many cases, in as much as there are a lot of medium sized companies which do not pay dividend and instead, retain the earnings in the company for re-investment. Thrusting MAT on companies is nothing short of penalisation for good performance.

The companies to suffer the most because of MAT are the huge capital intense industrial companies which have been putting up projects from time to time. More often than not, such projects are mega projects which any country desperately needs to stimulate growth. They are sources of employment for a big populace in and around the areas where they are put up. Levying MAT on these companies results in a disincentive to their efforts in putting up big projects.

The fact that many of the big corporates who earn substantial profits do not pay any tax may sound incongruous but the larger picture needs to be seen to correctly understand this phenomenon. While these companies may not be paying any direct tax but they contribute huge amounts of indirect taxes to the national and state exchequer. They pay hefty amounts of customs duty on the imported equipments as well as excise and sales taxes on indigenous purchases and turnover. What MAT does is to narrow the picture, confining it only to the direct tax contribution, and consequently distorting the overall picture. It is a fact that the so-called zero tax companies are among the largest contributors to the national exchequer and this fact needs to be clearly understood by the people who have a wrong notion about the contribution of these companies to the overall economic development of the country.

Need for Elimination of MAT

In the international context, it has been seen that the circumstances at the time of introduction of the MAT concept are entirely different from the current prevailing circumstances. In the United States, many of the tax incentrives that arguably allowed some highly profitable companies to minimize their tax outgo in the mid 1980's (safe harbor leasing etc.) no longer exist. In the earlier times, there were jungles of complex deductions and myriad of other exemptions which facilitated the zero tax syndrome. However, with increasing stress and emphasis that is nowadays being given by countries across the world to simplify and rationalise their tax laws, the rationale of having a so called "Minimum Alternate Tax" definitely needs to be revisited and reviewed.

Under Indian tax laws, the deductions allowable to companies for export profits or for investments in backward areas are gradually being phased out and therefore the relevance of having a parallel MAT system gets diluted to that extent. The accelerated depreciation under tax laws in comparison to the book depreciation still remains, but taxing this differential seems to contradict the basic aim of the Government to promote industrial growth by inducing the corporate sector to invest more.

It is quite ironical that at a time when the whole world is talking about and pointing out the needs to have more simple and more rational tax system, some governments are still continuing with provisions such as MAT, which create a sort of parallel tax system requiring intricate computations and adjustments and resulting in differing interpretations and legal disputes. The Indian government, in particular, has never had a stable policy regarding MAT and very often we have seen contradictory amendments being made with respect to MAT and its applicability. Frequent changes in tax policies do not provide a conducive investing environment and this fact needs to be realized at the earliest.

The adverse effects of having a Minimum Alternate Tax have been realized by many countries. Recognising that AMT (Alternate Minimum Tax, as it is known in the United States) is having a severe adverse impact on corporate capital expenditure spending. President George Bush, in his economic stimulus proposal to the Congress, made a strong case for elimination of AMT. It was recognized that such a Minimum Tax was inhibiting investment and was diminishing the value of various investment incentives, such as accelerated depreciation.

It would not be out of place to mention here that this move on the part of US, was not only on recognition of the adverse impact of MAT on its domestic companies, but it was also prompted by the realization that foreign investment was getting diverted to other countries with more conducive tax regimes. This fact is all the more relevant for developing countries like India, which are in desperate need of foreign investment. Assuming other factors to remain same, it is very obvious that any overseas investor would prefer to invest in a country with no MAT, e.g. China, rather than investing in India. The overall tax rate and the taxation structure in China is much more investor friendly and therefore the persistence with Minimum Alternate Tax reduces India's competitiveness to a great extent. Arguable it may be, but there is a view gaining strength that the concept of MAT is no longer relevant in the current economic scenario of stiff competition amongst countries trying to attract and promote investments. Some would even go to the extent of saying that MAT exists only to help governments evade adverse media comments on the idea of large companies paying zero taxes.

In fact, it viewed from a broader perspective, the very existence of MAT indicates that the taxing authorities do not appear to be very clear in their thought process about what exactly they want to achieve. In the first instance, they propose various forms of tax incentives to the corporate sector as an inducement to invest more. When companies go ahead, take the risks, invest money into big projects, and use these tax incentives to reach the so called zero tax or marginal tax paying status, the authorities then wake up with a knee jerk reaction and come up with such concepts as a "Minimum Alternate Tax".

It should be realized that the so called zero tax companies are not following any fraudulent tax practices but are only planning their tax liability in a legal and healthy manner, using the incentives which are existing in the rulebook. It should not be forgotten that their overall contribution to the national exchequer is quite meaningful and substantial.

What is actually needed is to have a clear, long term roadmap of a suitable and desired tax regime instead of having short term, conflicting measures such as incentives for capital spending on one hand and Minimum Alternate Tax on the other. One cannot give from one hand just to take away from another.

In India as well as internationally, the implications of MAT have been discussed and researched in great detail and the overall view seems to be that there is a very strong case of Minimum Alternate Tax (in whatever form it exists in various countries). The repeal of MAT would promote greater capital spending; facilitate better cash flows; reduce the cost of capital; create additional employment opportunities; and above all, accelerate overall economic growth. ■