India Needs Allowance For Equity and Compulsory Dividends to Woo Back Retail Investors

In most of the corporate income tax systems across the world, interest is deductible as expenditure in the calculation of taxable profits, while dividends are not. This difference in the treatment of returns to equity and debt is often seen as a discrimination against equity finance. The essence of this proposal is that the system should give an equity allowance for the costs of equity finance in the same way that relief is given for the costs of debt finance, in order to become neutral to financing or capital structure. As such a marginal investment will always be worth undertaking, as the system should ensure that it will bear no tax. Allowance for Corporate Equity coupled with compulsory dividend makes a perfect choice to the ills of high leverage and also set high standards for corporate governance in countries like India.

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What is Allowance for Corporate Equity (ACE) and Compulsory Dividends

(1) Allowance For Corporate Equity

A different approach to equalising the tax treatment of debt and equity finance was proposed by the IFS Capital Taxes Group (1991). The basic idea is to provide explicit tax relief for the imputed opportunity cost of using shareholders' funds to finance the operations of the company. This 'allowance for corporate equity (ACE)' can be thought of in two ways: either as a counterpart to allowing the interest cost of debt finance to be tax deductible, or as a series of deferred tax allowances which compensate for the absence of the up-front 100% allowance for equity-financed investment expenditure provided by the cash-flow taxes. These two interpretations are broadly equivalent in examples with perfect certainty about future returns, while the second interpretation turns out to be more

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appropriate in the presence of risk and uncertainty. The effect is again to remove the normal return on equity-financed investment from the corporate tax base.

Broadly speaking, the stock of shareholders' funds used to compute the ACE allowance evolves according to: - Closing stock = Opening stock + Equity issued – Equity (re-) purchased + Retained profits as computed for tax purposes. The ACE allowance for the current period is then obtained as an imputed return on the closing stock of shareholders' funds at the end of the previous period (i.e. multiplying this stock by a specified rate of interest). Here, equity (re-purchased includes the acquisition of equity or additional equity in subsidiaries that the company acquires or whose expansion the company finances, as well as any share buy-backs. Retained profits as computed for tax purposes correspond to taxable profits (net of the ACE allowance) minus tax paid to the government and minus dividends paid to shareholders.

The idea of an ACE is to address the difference in the treatment of debt and equity, by allowing firms to deduct a notional interest rate on their equity as well. Specifically, the ACE or the notional return is defined as the product of the end of last year's equity stock, E_{t-1}, with a notional interest rate i. The notional interest rate should be defined as the risk free nominal interest rate because the tax advantages are certain. It could be approximated by the rate on government bonds.

Properties of ACE:

1) The ACE system ensures neutrality for financing choices. Firms will thus be indifferent between debt and equity finance, at least regarding the corporate tax implications.
2) The ACE system is neutral to investment. Therefore, no tax is charged on marginal projects, as for such projects the notional return will exactly match the pre-tax profits. Hence, any investment that would be worthwhile in the absence of tax remains worthwhile when taxed.
3) The method of tax depreciation is irrelevant under an ACE system. Any increase in depreciation in early years, will reduce the stock of equity and hence the ACE in later years, which exactly offsets in net present value terms any benefit from earlier depreciation.
4) The system is also unaffected by inflation. Any increase in monetary profits that is due to inflation will be offset by a higher notional return, as the notional interest rate will also be higher as a result of inflation. Indexation is therefore unnecessary.

The ACE thus achieves far more than just equal treatment of debt and equity finance, and from the list of properties above, it would appear to be such a great system, that it is a puzzle as to why more countries have not implemented it.

(2) Compulsory Dividends

Dividend payout limits the free cash flows available to the management and exposes them to additional monitoring from the external financing market. The need to pay dividends tends to make the management more accountable to shareholders and less prone to taking risks. Normally, a stockholder would have to sell his or her stock in order to profit from his or her investment in a company. Dividends allow investors to profit from their investment in the company without selling their stock. It aslo provides investors protection during bear markets. Dividends paid are part of total return and companies that pay dividends are usually historically stable.

Many non-dividend paying firms claim that paying dividends reduces their ability to reinvest, specially of Indian mid and small size firms where the cost of raising equity is quite high. However, Studies elsewhere, where compulsory dividend policy is in place, has suggested that this had no impact on long term reinvestment capabilities of the firm. In fact, cost of equity improves dramatically, as inflows from institutional investors spreads across market capitalisation, thereby increasing the investible universe, which is usually quite concentrated in large cap stocks.

Need for ACE & Compulsory Dividends

1. To Reduce Debt Bias

Most tax systems today contain a "debt bias," offering a tax advantage for corporations to finance their investments by debt. Debt bias threatens public revenues, because it enables companies to reduce tax liabilities by using hybrid financial instruments as well as by restructuring their finances internally, moving

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debt between affiliates. These traditional distortions of debt bias have long been recognised. Debt bias also creates significant inequities, complexities, and economic distortions. For instance, it has led to inefficiently high debt-to-equity ratios in corporations. The economic crisis has also made clear the harmful economic effects of excessive levels of debt in the banking sector, especially due to the systemic effects of bank failure. These insights make it more urgent to tackle debt bias by means of tax policy reform.

2.To Enhance Corporate Governance

The Corporate Governance problem in India is another reason as to why only 10% to 12% of household financial assets are invested in equities. The governance issue in the western world is different from India, in that, corporate governance aims essentially at disciplining the management, which has ceased to be effectively accountable to the owners. But in India the problem is different. Here, it is of disciplining the dominant shareholder and protecting the minority shareholders, as minority shareholders are mere spectators in the major corporate decision making process.

The Satyam Scandal: The scandal that caused Satyam Computer Services Ltd. to collapse in 2008, shaked the confidence of retail investors in the stock market, specially after it won the coveted Golden Peacock Global Award for Excellence in Corporate Governance for 2008. The organisation was named the winner by The World Council for Corporate Governance (WCFCG).

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3. To Improve Equity Culture in India

India has witnessed a very low equity ownership despite one of the highest household savings rate, globally. The reason behind this is the investment pattern of Indian households' savings. Nearly 35% of the household savings are channeled into physical assets such as property and gold. In 2010 alone, Indians have bought 963 tonnes of Gold worth ₹ 1.73 lakh crore (Source: World Gold Council). Further, financial assets are dominated by traditional fixed income securities thereby restricting the scope for capital appreciation. Bulks of the households' financial assets (more than 60%) are in the form of cash and bank deposits.

How does it work

Applying the Brazillian ACE System to the BSE 500 Index, wherein the law requires companies to pay mandatory dividends of atleast 25% of their net profit, it can be observed that companies will be left with less cash as compared to before and will be forced to improve on their management of cash, allocating cash to the best investment opportunity available.

Table : Financial Statements*

Balance Sheet (Rs.Cr.)	Current	ACE
Equity or Shareholder funds	12,93,664	12,93,664
Charge on Allowance for Equity	-	5.50%
Allowance on Equity	-	70,531
Total Equity	12,93,664	12,23,133

Income Statement (Rs.Cr.)	Current	ACE
Profit Before Tax	**2,86,212**	**2,86,212**
Effective Tax Rate	23.9%	23.9%
ACE Tax allowance to corporate (a)	-	16,857
Effective Corporate Tax	68,542	68,542
Total Tax Expense	**68,542**	**51,685**
Profit After Tax (b)	**2,17,670**	**2,34,527**
Dividend Payout	**23.1%**	**30.1%**
Dividends Proposed	**50,214**	**70,531**
Allowance on Equity (c)	-	70,531
Dividends	-	0
Retained Earnings (d)	**1,67,456**	**1,63,996**

**Excluding Government Companies*

Interest on Equity is deducted directly from Shareholder funds & not routed through P&L

a) ACE of 5.5% (Assumed G sec Yield) of total Net worth applied.

b) ACE impact does not flow through PAT (except tax shield) to avoid reduction of PAT thereby PE multiple & Market Cap.

c) Dividends would be classified as Allowance on Equity to gain tax advantage as Allowance on Equity is Tax Deductible, however, the % Charged on equity, as Allowance on Equity, would be capped at the long term G-Sec rate (as decided by authorities).

d) The reduction in Retained Earnings is due to the difference between the Increase in PAT & Dividends Paid Out from Current to ACE.

In Financial Year 2011, the net cash received by shareholders in the BSE 500 Index, in the form of dividends after deduction of the necessary taxes, is ₹42,079 crore. And that received by government is ₹76,677 crore. And the corporate is not eligibile for any benefits and retains earnings worth ₹1,67,456 crore. The dividend payout remains close to 25% i.e. ₹50,214 in dividends paid out from PAT of ₹2,17,670. So why adopt ACE?

It is observed that at the end of Financial Year 2011, barring the government run companies in the BSE 500, only 50% of the companies' dividend payout was of a minimum percentage compared to a similar Charge on Interest on equity. If ACE had been in practice, the corporate would enjoy a tax benefit of ₹16,857 crore but would see its earnings retained, fall to ₹1,63,996 crore. Taxes received by the government would also come down, though not much, to ₹62,265 crore. The biggest winner in this scenario would be the owners i.e. the shareholders of the company receiving an amount of ₹59,105 crore after deduction of necessary taxes.

Table : Companies from BSE 500 Index (440 companies*)

Quartile (₹Crs)	Market Cap	Net Profit	Dividends	Dividend Payout
Q1	17,76,535	65,340	30,679	47.0%
Q2	9,63,462	55,340	11,675	21.1%
Q3	8,66,525	63,028	6,853	10.9%
Q4	6,07,288	33,599	963	2.9%

**Excluding Government Companies*

From the above table, it can be observed that almost 50% of Net Profit (Q3+Q4) of BSE 500 (excluding government companies) has a dividend payout of a mere 8% and command a combined market cap of ₹14,73,813 crore.

International Experience

A number of countries have successfully introduced variants of the allowance for corporate equity, suggesting that it is not only conceptually desirable but also practically feasible. Given below are some of the countries that have adopted different variants of the ACE model:

A. *The Brazilian Model: (1996 – Present)*

Brazilian Corporate Law requires that the bye laws of Brazilian companies specify a minimum percentage of the available profits for the yearly distribution of dividends by the company, known as the mandatory dividend, which must be paid to shareholders as either dividends or interest on shareholders' equity. Dividends paid as interest on shareholders' equity are deductible expenses for purposes of the Corporate Income Tax *(Imposto de Renda Pessoa Jurídica)*, or IRPJ and the Social Contribution on Net Income *(Contribuição Social Sobre o Lucro Líquido)*, or CSLL.

In one its recent working paper, IMF has indicated that various governments across Europe are having discussion to adopt some form of ACE in order to reduce the debt bias that has led to meltdown of the global financial markets.

B. *The Italian Model: (1997-2003)*

The main feature of the Italian variant is that notional interest is not tax deductible, but instead qualifies for a reduced corporate income tax rate. Two further restrictions are that only post-reform equity is counted and that the average tax rate must not fall below a minimum of 27% (which is close to the average of the standard and reduced rate).

C. *The Austrian Model: (2000-2004)*

The system allowed for fictitious interest on the equity increase over a year to be deducted from the corporate income tax base of that year. The equity interest was calculated in the following way: The applicable interest rate on equity was set by a directive of the Austrian Federal Minister of Finance at a rate corresponding to the average of secondary market yields for all issuers on the domestic bond market from January to December plus 0.8 percentage points. The Austrian Income-tax Act defined the incremental equity in year t as the difference between the weighted average equity over year t (calculated on a daily basis) and the maximum of the weighted average equity of the previous seven years. The resulting interest on incremental equity was deducted from the corporate tax base as an operating expense. The amount deducted was to be recorded as 'special earnings', which were to be taxed at a rate of 25% (equalling the withholding tax rate on dividends and interest income) instead of the "standard" corporate tax rate of 34%.

D. *The Belgian Model: (2006 - Present)*

Belgian companies or foreign companies permanently established in Belgium can deduct from their taxable income what is called a "Risk Capital Deduction", which is an amount computed

as the fictitious interest cost of the adjusted equity of a company. Hence, not the actual equity cost, i.e. the return to shareholders, but an estimated equity cost is tax deductible.

Global Facts

Country	Indices	Dividend Yield (%)
Venezuela	Caracas Stock Exchange Stock Market Index	9.0
France	France 'CAC 40 Index	4.7
Brazil	Bovespa Brasil Sao Paulo Stock Exchange Index	4.5
England	FTSE 100 Index	4.2
Belgium	BEL 20 Index	3.7
China	Hong Kong Hang Seng Index	3.6
Russia	MICEX Index	3.5
Thailand	Stock Exchange of Thailand SET Index	3.4
Latvia	OMX Riga Index	3.2
Chile	Chile 65 Index	2.8
Philippines	Philippines Stock Exchange PSEi Index	2.7
U.S.A.	Dow Jones Industrial Average	2.7
Greece	Athens Stock Exchange General Index	2.4
Japan	Nikkei 225	2.3
China	Shanghai Stock Exchange Composite Index	2.2
India	BSE India Sensex 30 Index	1.6
India	National Stock Exchange S&P CNX Nifty Index	1.6

** 12M Rolling Dividend Yield (Source: Bloomberg) (As on 26-6-2012)*

Each country has drawn its inspiration from the uniqueness of the problem it has faced and has adopted a system which has suited it the best. Recently, Chinese Security Regulatory commission (CSRC) has expressed a strong opinion on low dividend payout by listed entities and framed rules for dividend payout for listed companies as well as IPOs. In one its recent working papers, IMF has indicated that various governments across Europe are having discussion to adopt some form of ACE in order to reduce the debt bias that has led to meltdown of the global financial markets.

Conclusion

As the economy treads the development path, households' discretionary spend will rise. This might lead to reduced savings and increased spending. This underlines the need for change in household portfolio strategy in favour of building net worth through the acquisition of wealth generating assets. By doing so, the reduction in savings can be more than offset by the increase in the net worth of the household, thereby creating a positive 'wealth effect'. Time and again, it has been proved that Equities are the best option for wealth creation. Over the long term, they have given the highest return among all asset classes. Anyone who had invested ₹1,000 in the Sensex at its inception (in April 1979) would now have over ₹1, 48,000 (as on 16th February, 2011); a phenomenal CAGR of 16.9% over 32 years. This is the kind of opportunity that is created by equity investments. However, there is still a long way to go before our stock markets stops being at the mercy of FIIs. Steps are thus needed in the form of tax benefits and a growth friendly regulatory environment for equity investments through direct, insurance as well as mutual fund channels.

Implementation of the ACE tax would preserve most of the structure of existing corporate income taxes, including depreciation schedules and interest deductibility. All that would be required would be to specify how the equity base used to compute the ACE allowance evolves over time, and which particular 'risk-free' nominal interest rate is used to compute the allowance. In most contexts, this could be approximated by the interest rate on medium-term government bonds.

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