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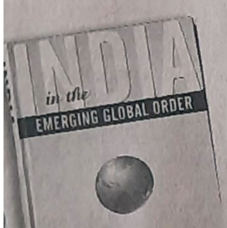

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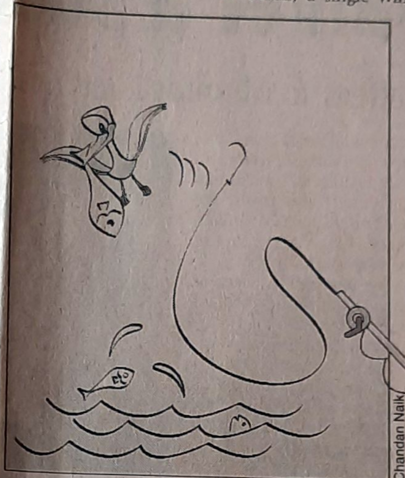
Fishing For Profits In The Tax Net

This article discusses impediments of taxation on SME investments and growth, pointing out the appropriate tax reforms that can bring sustained development

ONE of the purposes of taxation is adjusting the tax system in a way of favouring certain forms of industry – not allowing gross inequalities in capitalist competition. "Taxation policy should be used as a mechanism of correction of market imbalances by correcting social inequities and distortions in free competition," says Naina Savala, Practising Cost Accountant, NPS & ASSOCIATES. With tax rates remaining uniform for corporations of all sizes in India, this purpose of taxation seems to be defied for the SMEs in India.

In the first place, the classical corporate tax system continues to discourage equity financing for SMEs. "Currently, companies whether having a turnover of Rs 5 lakh or Rs 1,000 crore have same slabs of income tax. It is particularly detrimental to smaller companies as it retards capital accumulation and expansion," says Anil Bhardwaj, Secretary General, FISME. The narrow tax base in India has been depriving benefits of limited liability to SMEs, encouraging them to take up funds via debts, thereby reducing their incentive to invest. "In India, corporate tax works out to 34%, whereas in majority of the countries it is in the range of 17.5%-28%," says GV Aras, Head of Textile Engineering Group and Senior VP of ATE. Moreover, the DDT is causing double taxation by first taxing the profits and then taxing the distributed profits.


Chandan Naik

To top it all, SMEs continue to feel the pinch of employee retention because of Fringe Benefit Tax (FBT). "FBT has created headaches for the big units. SMEs are far more affected as they divert attention from productive activities to frivolous ones," says KM Pai, MD, Bell Ceramics Limited and Chairman, SME committee of FKCCI. FBT on ESOPs hit several compensation schemes, burdening employers with additional costs. "Currently, for most IT SMEs, sales related travel cost is about 7% and FBT on this would increase our cost of doing business in India," says Dr Sankaran P Raghunathan, Chairman, Blueshift India and President, IT SME Association.

Similar trend in indirect taxes has also affected the SMEs in manufacturing sector – blow from excise duties. "SMEs are affected by the levy of excise duty on goods manufactured on job work basis, at the principals' selling price, following which job workers have lost their cost competitiveness to a large extent," says Mr Aras. The current excise duty exemption from 16%-14% has not benefited the SMEs below the exemption limit level. "SMEs operating below the exemption limit may not be able to buy from the large manufacturers and get the central excise duty credits," says Mr Pai.

While specific exclusions have been provided in relation to certain services provided to the Government, various other services interpreted in a similar way continue to be taxable. Benefits in the form of VAT refunds are also subjected to unknown delays, thereby locking capital of SMEs. "The refund mechanism for VAT, service and excise duty is very poor in India. When the amounts become insubstantial, the cost of paper work and follow-up percentage increase," says Mr Pai. Moreover, there are no records specifying the exact scope of input services that are eligible for Cenvat credit, VAT and service tax. "No authentic information is available in one place about all regulatory requirements that need to be satisfied by the SMEs," says Dr Raghunathan. With the taxes being so demanding, SMEs pay heavy for complying. "Variety of taxes, duties, cess, cumbersome tax legislation and administrative policies contribute to non-compliance," says Ms Savala.

There are instances of SMEs shifting their base from an SEZ. "(Many) Indian SMEs keep their headquarters in Singapore, thus paying only 8% effective tax, enjoying very low operational costs and low employee attrition rate," says Dr Raghunathan. Any feature affecting the effective tax on SME investments should be replaced with appropriate tax reforms. Primary requirement for integrating taxes is making available information accessible and affordable to SMEs. "Just as the RBI has decentralised the filing of foreign exchange information to the banks, a single window should be appointed for SMEs. Online filing of the tax forms should be made easier and very less expensive," says Dr Raghunathan.

In case of direct tax reforms Ms Savala comments, "FBT and MAT should be eliminated and there should be lower DDT for SMEs." Amongst indirect taxes, GST seems to be the most favourable regime, as it will simplify tax base and reduce compliance costs. "A unified GST is ideal. It should be simple, certain and clear," says Mr Pai. Additional taxes affecting the expansion capabilities of the SMEs should be scrapped. "The exemption limit should be pushed upwards for the various central excise/service tax and compliance requirements for exempted units should be scrapped to reduce administrative cost," says Mr Aras.

The most important reform that can generate investments is the usage of tax incentives as a corrective policy instrument. "A weighted deduction of 150% or 200% may be given from the profits of an SME concerning expenditure incurred on research in the year in which expenses are incurred," says Ms Savala. "Cenvat credit on capital equipments and inputs should be allowed as credit and a time bound automatic refund mechanism put in place to enable reimbursements," says Mr Pai. Although [illegible] administrators can adopt a phased and progressive method towards the same. "Industry professionals should form a panel to study the simplification of taxes. Many countries are known for simple tax laws and they can be used as model bases," says Mr Pai.

In conclusion, there is discrimination against investment spending by SMEs during a high-growth phase in which investment spending is higher than current profits. To boost entrepreneurship in SMEs, it is important to allow a simple and neutral taxation system, rather than a system with many provisions and complexities of its own. "Unlike their larger counterparts, which can attract external funds, in bulk of SMEs the expansion is financed through internal accruals because of limited external funding avenues. Therefore, graded taxation for smaller companies would greatly help capital accumulation and in their attaining economy of scales," says Mr Bhardwaj.

– ESTHER BARDHAN