Conclusion

Considering the tax incentives are provided globally toward Infrastructure and Energy sectors, the tax incentives are still the need of the hour in India. More importantly, the profit-linked tax incentives are required as it improves the IRR of the project and thereby boosts private investments in this sector. Though in the Budget 2016, the Government has set the phase out date of profit-linked incentives at 31 March 2017, the industry could represent before the Government to continue it or further extend the timeline.

Secondly, if we take the phase-out of tax incentives as fait accompli, it calls for the relook by the developers into their strategy and recompute the IRR based on tax impact on their projects, especially in cases where projects are not envisaged to commence before the April 2017.

Are tax incentives necessary to boost Infrastructure and Energy Projects?

2016

Economic outlook vis-à-vis development of Infrastructure

A well-developed infrastructure is one of the key elements that drives the economic growth of any country. An established infrastructure would be the first point on the table when economists talk about the efficiency in production levels of the industry. For instance, how efficiently would a country reap the benefit of abundant natural resources present in the country if there is no adequate energy source to extract such resources and no suitable infrastructure to provide such resources in a timely and effective manner to the sectors that require it?

In today's globalized world, the countries realize that provision of good infrastructure facilities and adequate energy sources to businesses, households, etc., is the key challenge that needs to be taken. The 'World Bank Report 1994' categorically indicated that the productivity growth is higher in countries with an adequate and efficient supply of infrastructure services. The Report also points out that 'one percent increase in the stock of Infrastructure is associated with one percent increase in Gross Domestic Product (GDP)'.

Considering the need for investment in Infrastructure and Energy, Government of India has been increasing the targeted spend on infrastructure and energy in its Five Year Plans (FYP). The current 12th FYP has defined the infrastructure investment target of USD 1 Trillion which is more than double the target set-out in 11th FYP, and also, 30% of the required investment is targeted to be met from private sector.

Global outlook on tax incentives in Infrastructure and Energy sector

At this juncture, let us take a look into examples of tax incentives provided by some of the key developing and developed economies of the world as tabulated below:

Country	Sector	Incentive
China	**Renewable Energy**	**A reduced corporate income tax rate of 15 percent is granted to qualified advanced and new technology enterprises. Applicable fields include solar energy, wind energy, biomaterial energy, and geothermal energy.**
South Africa	**Special Economic Zones**	**A reduced corporate tax rate of 15% as well as a 10% allowance with respect to the cost of new and unused buildings owned by a qualifying company or any new or unused improvements to any building owned by a qualifying company**
Australia	**Infrastructure**	**Uplifting the value of unutilized carry forward losses each year at the 10 years Govt. Bond rate and also exempting carry forward losses & bad debts reductions**
Philippines	**Renewable Energy**	**Incentives to private sectors investments in renewable energy such as: 7 years tax holiday after the beginning of the commercial operations, duty-free importation of renewable energy machinery and zero % value-added tax rate for equipment and materials**
Brazil	**Infrastructure & Regional Development**	**For the Northeast and Amazon regions, 75% reduction of the income tax and non-refundable surcharges due on operating profit, for a maximum period of 10 years, for implementation, expansion, diversification and improvement projects submitted and approved from 24 August 2000 to 31 December 2018**

Note: The above table is prepared based on various information available in public domain.

By now, we all know that the tax incentives are offered globally to allure the investments in capital-intensive infrastructure and energy projects. We shall discuss the tax incentives provided in India and the recent paradigm shift proposed by the Indian Government.

Tax incentives as a means to enhance Infrastructure and Energy sector

Historically, several developing and developed countries have been focusing on private sector involvement in the Infrastructure and Energy projects. Considering the high-pitched investments and long gestation period, the governments generally go an extra mile to attract the private investments by incentivizing the sector, including offering various tax incentives.

The tax incentives could be in various forms such as tax holidays, investment allowances, tax credits, reduction in corporate / indirect tax rates, taxing based on timing differences, etc.

While the tax incentives may not be the only point of discussion while strategizing the investment options, tax cost is one of the key drivers of any investment decisions. Hence, if the IRR of the project can be made better by offering tax incentives, it could be one of the deciding factors for investments in many projects.

Tax incentives scenario in India

The Indian government has been offering the tax incentives to Infrastructure and Energy projects, especially, after the Economic Reforms of 1991. The sector-wise gist of incentive scenarios prior to Budget 2016 (for key infrastructure and energy sectors) is as under:

Sector	Tax incentive	Sunset clause
Power generation, distribution, or transmission	**Profit-linked 100% tax holiday deduction for any 10 years out of first 15 years**	**31.03.2017**
Development or operation and maintenance or development, operation, and maintenance of infrastructure facility (e.g., roads, highway projects, water supply projects, ports)	**Profit-linked 100% tax holiday for any 10 years out of first 15 / 20 years**	**No sunset date**
Special Economic Zones developers	**Profit-linked 100% tax holiday deduction for any 10 years out of first 15 years**	**No sunset date**
Production of mineral oil and natural gas	**Profit linked 100% tax holiday for first 7 years**	**No sunset date**

Recently, the Indian Government has announced phasing out various tax-incentives on the ground that it would bring greater clarity to tax law, reduce tax rates, simplify the administration and improve India's competitive edge globally. As we all are aware, the government is trying at reducing corporate tax rate of 25% (which is in line with the present effective tax rate of 24%) and phasing out the incentives to strike the balance.

Accordingly, the overall mindset is changing with phasing out of tax incentives and / or shifting from profit-linked incentives to investment-linked investment in certain cases. In this regard, the Indian Government has announced phasing out profit-linked tax incentives for SEZ developers and mineral oil / natural gas producers. For developers of infrastructure facility, the gears have shifted from profit-linked incentive to investment-linked incentive. Further, phasing out accelerated depreciation is proposed (which will affect renewable power projects), but there is no word from the Government on the fate of profit-linked tax incentive to power projects for which the sunset date is 31 March 2017.

While the Government would have done its homework before this paradigm shift, investment-linked tax incentive only led to deferment of taxes to a future year as against the revenue outgo for the government in the profit-linked tax holidays. As such, the industry has a perception that there is no real benefit in investment-linked tax incentive, except the timing difference.

Further, there would be an impact on IRR of each project while shifting from profit-linked tax holiday to investment-linked tax incentive / no incentive. We have illustrated the difference in IRRs of a typical energy project under different scenarios such as existence of profit-linked tax holiday or investment-linked tax incentive and no tax incentive, as under:

Year	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
Scenario 1: Profit-linked tax holiday																
Initial investment	300	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Revenue	-	100	110	121	133	146	161	177	195	214	236	259	285	314	345	380
Expenses	-	75	83	91	100	110	121	133	146	161	177	195	214	235	259	285
Depreciation	-	30	27	24	22	20	18	16	14	13	12	10	9	8	8	7
Net profit before tax	-	(5)	1	6	11	17	23	28	34	41	47	54	62	70	79	88
Tax cost	-	0	0	0	0	0	0	0	0	0	0	0	19	21	24	26
Cashflow	(300)	25	28	30	33	37	40	44	49	54	59	65	53	57	63	69
IRR								11%								
Scenario 2: Investment-linked tax incentive																
Investment	300	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Revenue	-	100	110	121	133	146	161	177	195	214	236	259	285	314	345	380
Expenses	-	75	83	91	100	110	121	133	146	161	177	195	214	235	259	285
Investment allowance	-	300	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Net profit	-	(275)	28	30	33	37	40	44	49	54	59	65	71	78	86	95
Tax cost	-	0	0	0	0	0	0	0	0	12	18	19	21	24	26	28
Cash Flow	(300)	25	28	30	33	37	40	44	49	42	41	45	50	55	60	66
IRR								10%								
Scenario 3: No tax Incentives																
Investment	300	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Revenue	-	100	110	121	133	146	161	177	195	214	236	259	285	314	345	380
Expenses	-	75	83	91	100	110	121	133	146	161	177	195	214	235	259	285
Depreciation	-	30	27	24	22	20	18	16	14	13	12	10	9	8	8	7
Net profit	-	(5)	1	6	11	17	23	28	34	41	47	54	62	70	79	88
Tax cost	-	0	0	1	3	5	7	9	10	12	14	16	19	21	24	26
Cash Flow	(300)	25	28	30	30	32	33	36	38	41	45	49	53	57	63	69
IRR								9%								

As it can be seen from the above illustration, the IRR of the project reduces by 1% when the tax incentives shift from profit-linked holiday to investment-linked incentive. Furthermore, the IRR reduces by additional 1% in case where there is no tax incentive for the project. Accordingly, for a power sector where the profit-linked tax incentives are completely phased out from April 2017, the project would move from scenario 1 to scenario 3 causing considerable reduction in the IRR. The IRR would further worsen for renewable sector due to phasing out of accelerated depreciation from April 2017.

The aforesaid illustration is similar to the financial model for renewable power project which has comparatively low capital requirement and shorter gestation period. However, in case of high capital-intensive projects with longer gestation period such as ports, airports, conventional power projects, etc., the variance in IRR may increase in the above three scenarios.