CHAPTER IX

SOME SPECIAL CORPORATE TAXES IN INDIA

In most of the progressive countries of the world, corporations are taxed on their profits or income. But, it is already pointed out in chapter V that income alone cannot be regarded as an adequate measure of taxable capacity of an individual or a corporation. Further certain types of incomes such as capital gains are an important factor in aggravating economic disparities and there can be no justification for regarding capital gains as a species of income not liable to taxation. Therefore, a tax on corporate profits or income should be supplemented by a tax on capital gains and wealth. So also, in order to regulate and control the private companies in respect of their dividend policy, profit retention and inter-corporate shareholdings, some special taxes are to be devised. In India, though some of these special taxes are of a recent origin, a discussion of these taxes will serve an important purpose of explaining the rest of the part of the corporate tax structure of the country.

Since the taxation of inter-corporate dividend is discussed in chapter VI and taxation of controlled companies and of foreign companies is discussed in two separate chapters, in this chapter only three taxes, namely, capital gains tax, wealth tax and bonus share tax will be discussed.

CAPITAL GAINS TAX: - It will be interesting to note that most of the European countries have levied a tax on capital gains. These countries are: Belgium, Denmark, Finland, France, Holland, Norway, Switzerland and Sweden. In the U.S.A., capital gains have been taxed since 1913. Also, several countries in Latin America, such as, Argentina, Brazil, Cuba and Venezuela levy a tax on capital gains.

In India too, a capital gains tax was in force for two years during the period, April 1, 1946 to March 31, 1948. However, in 1949, this tax was abolished on the following grounds:-

(1) The tax did not yield any sizeable revenue because of declining values of properties.

(2) The tax hampered the free movement of securities in the capital market, which was a necessary pre-requisite for India's industrial development.

However, with some alterations, this tax was reintroduced under the Finance Act (No:3) of 1956. The new section 12B of the Income Tax Act charges capital gains resulting from the sale, exchange, relinquishment or transfer of capital asset effected any time, after 31.3.56. Under Section 2(4A) of the Income tax Act, "capital asset" means property of any kind held by an assessee, whether or not connected with his business, profession or vocation, but does not include:-

(1) any stock-in-trade, consumable stores or raw materials held for the purposes of business, profession or vocation.

(2) personal effects, that is to say, movable property (including wearing apparel, jewellery and furniture) held for personal use by the assessee or any member of the family (of the assessee) dependent on the assessee.

(3) any land from which the income derived is agricultural income.

It may be pointed out that the exceptions (1) and (3) are material in the case of companies. A company cannot claim to be in possession of personal effects or any movable property which can be said to have been held for personal use by the assessee company. Hence, it can be said that even the movable property owned by a company would give rise to a capital gain if the property were to be sold, exchanged or transferred for a consideration above the actual cost.

Under the old scheme which existed upto 1949, certain transactions actually being in the nature of sale, exchange or transfer were outside the scope of capital gains tax. For instance, gains which might arise as a result of the transfer of capital assets on account of compulsory acquisition; or gains from the distribution of assets on account of the dissolution of a company; gains arising on the transfer of assets to an irrevocable trust etc. were exempted from tax. Under the new scheme of capital gains taxation, these peculiar exemptions are dropped.

Under the old scheme, the gains arising from the transactions mentioned below were exempted:-

(1) gains from the distribution of assets on liquidation of a company, voluntary or compulsory.

(2) gains due to transfer by a parent company of its assets to a cent percent Indian subsidiary and resident company.

(3) gains on account of the sale of building, plant and machinery belonging to the business carried on by a company provided that they were invested in the purchase of new asset of similar kind within the specified period.

(4) gains arising from the transfer of property by a company if the property was compulsorily acquired under the Land Acquisition Act of 1894.

Under the new scheme of capital gains taxation, no special consideration has been given to the transactions (1), (3) and (4) above. Indeed, the transactions referred to in (2) enjoy a special consideration even under the new scheme. under which no tax is payable by a company which holds the entire share capital of a resident Indian company on the capital gain accruing to it by transfer of a capital asset to the subsidiary.

The capital gains tax in India is a tax on realised capital gains. That is to say, the tax is not payable unless and until the capital asset is actually sold, relinquished or transferred. While charging the tax on capital gains, originally the investment period was not taken into account. Irrespective of the period of investment, say, short period or long period, the rates of tax were applicable equally to all types of assets coming within the scope of capital gains taxation. But, under the Finance Act of 1962, a distinction between short term and long term capital gains has been introduced.

An assessee, a company or an individual, is given the option of paying the tax on any one of the basis as mentioned below:-

(1) An excess of the sale price of an asset over its original cost price.

(2) An excess of the sale price over its estimated market value on January, 1, 1954.

This shows that the capital appreciation which might have taken place upto January, 1,1954, is not subject to capital gains tax. Upto 1961-62 capital losses were allowed to be carried forward and could be set-off against capital gains in later years, provided no loss was carried forward for more than eight years.

One more notable feature of this tax is that the entire capital gain, whatever be its magnitude is charged to income tax at the same rate at which income under any other head is charged. This is so because income under the head "capital gain" is includible in the total income of the assessee company like any income under any other head and also because there is no exemption limit in the case of companies for charging their total income to income tax. Thus, although in the case of assess--ees other than companies, "capital gains" can be charged to tax only if they exceed Rs.5,000 and if the total income including capital gains exceed Rs.10,000, no such limits of exemption are prescribed in the case of companies.

It may also be pointed out that all other assessees (except companies) have to pay income tax on capital gains at a reduced rate which equal to the rate applicable to the total income as reduced by 2/3rds of the amount of capital gains. This relief in the rate of taxation of capital gains is not available to a company, since a company is charged capital gains tax at a uniform rate of 20 percent income tax and 10 per-cent super tax. Thus, in the case of companies, the whole amount of capital gains bore tax at a rate of 30 percent. These were the main features of capital gains tax upto 1961-62.

The Finance Act of 1962, has introduced two important changes in the law relating to capital gains and capital losses. First, capital gains made on the sale of short term capital assets i.e. assets disposed of within a period of one year of their acquisition, are to be taxed at the usual rates applicable to business profits. The long term capital gains will bear tax at the maximum rate of 30 percent in the case of limited companies. Secondly, losses arising on the sale of long term capital assets will not be allowed to be carried forward. During 1947-49 and 1956-62 a company was allowed to carry fo8ward losses against gains for a period of eight years.

Thus, the new Act proposes to change the whole basis of assessment of capital gains. The capital gains hereafter will be distinguished between gains arising on short term capital assets and gains arising on capital assets other than short term capital assets. The term "short term capital asset" is defined as a capital asset which is held for not more than twelve ~~[illegible]~~ months, immediately preceding the date of transfer. Also it is now proposed that there should be a separate treatment for carry forward of losses for the following three types of losses:-

(1) Loss on short term capital assets:- Loss incurred on sale of short term capital assets will be set off against income in respect of any other capital asset. The balance of loss, if any, will be carried forward and set off against the capital gains relating to short term capital assets only in subsequent years for a period of eight assessment years.

(2) Loss on capital assets other than short term capital assets:- Loss on such assets will in the first instance be set off against income in respect of any other capital asset not being a short term capital asset.

From the above, it becomes clear that hereafter capital losses on short term capital assets will be allowed to be set off only against gains from capital assets in the year in which they are incurred, and for a period of eight years thereafter, only against gains relating to short term capital assets.

On the other hand, loss on capital assets other than short term capital assets will be allowed to be set off only against gains relating to capital assets other than short term capital assets. The balance of loss, if any, in case of such capital assets will not be allowed to be carried forward at all.

The Act also seeks to provide for a splitting of the capital losses relating to earlier years, i.e. prior to the assessment year 1962-63, and brought forward to be set off in 1962-63 and thereafter, into losses relating to short term capital assets and those relating to other capital assets. Hereafter, only losses relating to short term capital assets will be allowed to be carried forward and set off as aforesaid, while losses relating to other capital assets other than short term capital assets will lapse.

The capital gain, on either short term or long term capital assets, will be charged as part of total income. On the other hand, the amount of super tax will be equal to the aggregate of the amount of super tax at the rate of 5 percent on the capital gains relating to capital assets other than short term capital assets. It would mean that the gain on short term capital assets will be chargeable to tax in the hands of the company, just like any other income.

Thus, the Finance Act of 1962 has sought to introduce certain radical changes in the capital gains tax system. These changes have been severely attacked by critics. If a company wants to off-set its losses on long term assets in a particular year, it may have to compulsorily sell off the appreciated assets. Also, it has been pointed out that the proposed provisions regarding profits and losses on the sale of short term capital assets have, for the tax payer, all the burdens of assessments on business income without the corresponding advantages. Business income bears income tax and super tax at the ordinary rates and now the same burden is proposed to be borne by short term capital gains. But, when it comes to the treatment of losses, the business income is treated much more favourably than the income from investment.

WEALTH TAX:- The Wealth tax on companies was levied in 1957. This tax was levied on the net wealth of companies, which was defined as the aggregate value of all assets belonging to the company less the aggregate value of all the debts owned by it. All companies, whether private or public, Indian or foreign, were liable to pay the wealth tax. Ordinarily, a resident company had to pay this tax on its total wealth, whether such wealth was held in India or not. The first Rs.5,00,000 of net wealth were exempted from the tax and the balance was chargeable at a flat rate of 0.5 percent.

The notable exemptions from this tax were as follows:-

(1) Banking, insurance and shipping companies and certain financial institutions sponsored by the Central Government and also the institutions of art, culture, commerce not working for profit, though registered as companies.

(2) Inter-corporate investments i.e. shares held by one company in another company.

(3) New industrial companies for five successive assessment years.

(4) The portion of the assets of industrial companies which were employed on new and separate industrial units set up by way of substantial expansion.

(5) A company which had incurred net loss in any year and which had not declared any dividend on its equity capital.

(6) Where the profits made by a company in any year were less than the wealth tax due for the relevant assessment year and it had not declared any dividend, the tax payable

was limited to the amount of profits.

India was the seventh country in the world to buy a wealth tax on companies. The other countries are:Norway, Sweden, Denmark, West Germany, Austria and Switzerland. Japan and Netherlands adopted this tax but had to give it up.

This tax was severely criticised. Firstly, it should be remembered that the justification for wealth tax on individuals is that evenwhen the wealth does not yield its owner any income, it does give him both a real satisfaction and a security which make it a good object of satisfaction. This justification does not hold good in the case of companies whose all assets are presumably being productively employed even if not at a profit. Secondly, this tax was a disincentive to investment in such activities as on the whole tended to give relatively low rates of return to the investor. Thirdly, the wealth tax on companies together with the wealth tax on shareholders may lead to double taxation. Fifthly, the danger of the tax is that this tax may, on the one hand, adversely affect the accumulation of corporate reserves and on the other hand, it may discourage the equity financing of corporate investment. Lastly, the tax was levied at a low rate of 0.5 percent. So, the total collections till March 31,1958, were only Rs.6.5 crores.

The Finance Minister, therefore, abolished this tax in the Budget for 1959-60 in such a way that the tax on corporate profits would compensate for the loss of revenue which the wealth tax yielded.

TAX ON BONUS SHARES:- In India, a tax on bonus shares was levied in 1956 in order to prevent the companies from evading the excess dividend tax by increasing their paid-up capital through the capitalisation of their reserves by issuing bonus shares. Under the existing system of India's company taxation, tax liability attaches to the company on the mere issue of bonus shares and to the shareholder when the same are sold at profit, as capital gains are now charged to tax. In 1956, the rate of tax on bonus shares was fixed at 30 percent of the amount of bonus shares.

A number of arguments can be put forward in justification of a tax on bonus shares. Firstly, the issue of bonus shares will not be tantamount to releasing any part of the assets of the company to the shareholders and will therefore not fall within the purview of income tax. Thus, if no tax were levied on the issue of bonus shares by the company, the company will not pay any tax on it and the shareholder will not pay any tax because bonus shares are not "dividends" in their hands. Further, if no tax was levied on capital gains, the shareholders would sell the bonus shares at profit without paying any tax on such profits. In this way, this would be a convenient device used for the distribution of profits of the company without involving any tax liability on the part either of the company or the shareholder. Secondly, companies which have to pay excess dividends taxation may evade this tax if there were no check on the issue of bonus shares. The companies could widen their equity base by issuing bonus shares and consequently be in a convenient position to distribute large dividends to their shareholders without incurring any tax liability to excess dividend tax. Thus, the companies could defeat the very purpose of excess dividend tax.

Against these arguments favouring a bonus share tax, a number of counter-arguments are advanced. Firstly, bonus shares are issued by the companies to capitalise their reserves or accumulated profits. They result in the balance sheet reflecting more accurately the total capital invested in the business. The issue of bonus shares involves a mere accounting entry and a purely paper transaction. It does not change the total capital invested. Nor does it increase the earning power of the business. The issue of bonus shares merely increases the paid-up capital of a company and to that extent reduces its reserves. Moreover, shareholders do not derive any benefit from the issue of bonus shares because the total assets and the earning power of the companies are not affected by bonus shares. Secondly, the contention that the bonus shares tax would prevent the companies from evading the excess dividends tax by increasing their paid-up capital through capitalisation of their reserves, will hold good so long as it is assumed that the dividend distributions are calculated for the purpose of taxation on the basis of paid-up capital. Actually, this basis has proved to be inequitable and without any justification. In the productive employment of capital, there is no distinction between paid-up capital or reserves or loan capital. It is the employment of total capital which yields a return and not just the paid-up capital. Thirdly, it is interesting to note the basic conflict in the principles underlying the excess dividends tax and the bonus tax. The excess dividend tax was expected to penalise the distribution of large dividends and aim at encouraging the reinvestment of profits in the business; whereas the bonus tax discourages the ploughing back of profits into the business and the building up of large reserves. It can therefore be said that a tax which hinders the ploughing back of profits is in the long run a hindrance to economic development. Lastly, with the abolition of the excess dividend tax under the new scheme of company taxation in 1959, the tax on bonus issues had lost its justification.

Inspite of the above mentioned criticism of the bonus tax, the Government has not discontinued this tax. But in 1961, the tax is lowered from 30 percent to 12½ percent. This reduction is not to be looked at merely as a reduction in tax, but it has a far-reaching economic effect. It will widen the equity base of the company and restore the imbalance between the paid-up capital and fixed assets. Companies will be able to bring their share capital in line with their investment in fixed assets. In the absence of capitalisation of reserves, one significant misunderstanding that existed was that companies were said to be profiteering when on a ten-rupee share, a dividend of Rs.15 was given. This wrong belief which arose as a result of relating the rate of dividend to the share capital alone and not to the entire equity of the shareholders consisting of share capital and reserves, could now be dispelled. With the reduction of the bonus tax, the return on shares will appear more in line with reality than before.

The Finance Minister must have shrewdly estimated that the yield of tax on bonus shares at 12½ percent will be much more than at 30 percent. Because, immediately following the reduction, there has been a spate of bonus issues. It can be confidently stated that more tax will be collected at 12½ percent than at 30 percent. Ofcourse, it can always be argued that this tax is never imposed as a means of raising revenue but as an instrument of economic policy.

One technical point in regard to the issue of bonus shares is that if a company's reserves have been built up partly out of section 15-C profits (i.e. profits enjoying a tax holiday) and partly out of other profits, it may not be wise on its part to capitalise the reserves built out of section 15-C profits, which when distributed, will be exempt in the hands of the shareholders. The capitalisation of such profits would mean that these profits can never be distributed as dividends. In view of this, a company may segregate its reserves which have been built up out of section 15-C profits and not capitalise them and keep them free for distribution so that at a later date the exemption can be claimed under section 15-C(4) of the Act. Only reserves consisting of non-exempt profits may be utilised for the purpose of the issue of bonus shares. This much about the bonus shares tax.

The above discussion on capital gains tax, wealth tax and bonus shares tax clearly explains why these special corporate taxes are necessary. It also explains the fact that these taxes have certainly broadened the tax base of the companies in India. In some of the European countries, these three taxes and also taxes on controlled companies and on foreign companies are named as "special purpose taxes", since they are levied to serve some specific purposes.