

CHAPTER XI

SCOPE FOR COMPANY TAX REFORM IN INDIA (PART I)

"On the whole, the kind of tax system which would be best adopted to meet the requirements of the Indian economy, having regard to the development programme and the resources required for it, appears to be one which would increase the resources for investment available to the public sector with as small a diminution as practicable of investment in the private sector, and which, therefore, is accompanied by the largest practicable restraint on consumption by all classes".⁽¹⁾

The above point of view highlights some basic postulates of a desirable tax system in India. These postulates are chalked out with reference to the Government's ambitious development programme, its adherence to the principle of mixed economy under which the corporate sector will have a positive role to play, and the necessity of raising the aggregate level of saving in the country. From the point of view of the corporate sector of the economy, this may be looked upon as the minimum condition that a tax system should satisfy.

(1) Report of the Taxation Enquiry Commission, 1953-54, Vol.I, page 149.

In the light of the above postulates of a desirable tax system for the corporate sector of the economy, one pertinent question that can be raised is: what type of tax reform would be necessary ? Ofcourse, in general, a tax reform may be designed in relation to one or more purposes such as:-

- (1) Serving as an effective tool of resource mobilisation.
- (2) Providing for more revenue.
- (3) Achieving a more equitable distribution of income and wealth.
- (4) Achieving certain anti-inflationary or anti-depression effects.

Since no tax reform can simultaneously fulfill all the purposes mentioned above, quite obviously only one or two most urgent purposes should form the basis of a tax reform. Any scheme of tax reform should ensure that corporate taxation provides for the genuine needs of the expanding corporate sector. The need of more effective resource mobilisation and better resource utilisation will have to be emphasised.

India's company tax system, and especially its rates structure, has been patterned after the British tax system which traces its basic concept back at least to 1803. The ~~back~~ system of company taxation in India was never thought

of, nor designed, in relation to the development of the country's economy. It was designed primarily with the revenue motive. Only in 1956 when Mr. Kaldor drew pointed attention to the drawbacks of the system that the Government realised the need of rationalising it. Mr. Kaldor observed that, "the very multiplicity and complexity of these provisions is bound to act as a serious drag on the general efficiency of tax administration. I feel sure that the real disadvantages of the present system lie as much in the general uncertainty which they create as in the inequities and burdens imposed".⁽²⁾

Though these remarks are more directly applicable to the company tax system as it grew upto 1956, their general applicability has not lost its force even today.

The reform of company taxation may be thought of in relation to two important aspects, namely, tax rate and tax base. To start with the rate of company tax, a question may be raised as to what should be the tax rate that may not adversely affect the investment decisions or the development programme. It is not easy to answer this simple question. Ofcourse, theoretically one may talk of an optimum rate of tax. But, in actual practice, it

(2) Indian Tax Reform, 1956, by Nicholas Kaldor, page 92.

is very difficult, if not impossible, to arrive at an optimum rate of tax. No country of the world has been able to fix a particular rate of tax once and for all. Most of the countries of the world have been altering— increasing or decreasing— their company tax rates. It shows that it is not desirable or practicable to arbitrarily fix the company tax rate. Moreover a tax rate has to be adjusted to the other more important aspect of taxation namely, tax base i.e. deductions and concessions available under the tax system. Therefore, whether a country has a good or bad type of tax system will mainly depend on the extent to which their adjustment or coordination has been achieved. If a country's tax system does not conform to this basic principle of adjustment or coordination, it is bound to cause certain anomalies in course of time.

Those who ignore this very important problem of "tax adjustment" or "tax coordination", merely compare the Indian company tax rates with those of some capital exporting and/or capital importing countries and try to find out whether Indian tax rates are conducive or deterrent to investment. But, this seems to be a wrong approach to the study of the different tax systems of the world. International comparisons of tax rates alone may not enable one to arrive at scientific observations and unbiased conclusions.

It is the volume and rate of profits which effectively influence the decisions with respect to investment and saving or profit retention. And, the volume and rate of profits are determined not only by the tax rate but also by the available tax deductions and concessions. Hence it is suggested that while trying to compare the incidence of Indian company taxation with that of other countries, it would be absolutely necessary to take into account both the tax rate and the tax base. The following table gives a broad picture of the burden of company taxation (taking into account both tax rate and tax base) in India, the U.S.A. and the U.K. for a period of ten years:-

(IN PERCENTAGES OF GROSS PROFITS)

| Year | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |
|-----------------------|------|------|------|------|------|------|------|------|------|------|
| Appropriation | | | | | | | | | | |
| Total Profits | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 |
| Depreciation charge | 62.5 | 56.2 | 50.8 | 45.4 | 40.8 | 46.2 | 33.3 | 30.0 | 27.1 | 24.2 |
| Management charge | 1.9 | 2.3 | 2.5 | 2.7 | 3.0 | 3.3 | 3.4 | 3.5 | 3.6 | 3.8 |
| Profits before tax | 35.6 | 41.5 | 46.7 | 51.8 | 56.2 | 60.5 | 63.3 | 66.5 | 69.3 | 72.0 |
| Tax in:- | | | | | | | | | | |
| (i) India | - | - | - | 12.1 | 13.1 | 27.2 | 28.5 | 29.9 | 33.2 | 32.4 |
| (ii) U.S.A. | 17.4 | 20.5 | 23.2 | 25.8 | 28.1 | 30.4 | 31.8 | 33.5 | 35.0 | 36.3 |
| (iii) U.K. | - | - | 23.1 | 25.3 | 27.4 | 29.5 | 30.8 | 32.4 | 33.8 | 35.1 |
| Profits after tax in: | | | | | | | | | | |
| (i) India | 35.6 | 41.5 | 46.7 | 39.7 | 43.1 | 33.3 | 34.8 | 36.6 | 38.1 | 39.6 |
| (ii) U.S.A. | 18.2 | 21.0 | 23.5 | 26.0 | 28.1 | 30.1 | 31.5 | 33.0 | 34.5 | 35.7 |
| (iii) U.K. | 35.6 | 41.5 | 23.6 | 26.5 | 28.8 | 31.0 | 32.5 | 34.1 | 35.5 | 36.9 |

Based on Sources: (1) Data collected from the British Tax Review, November-December, 1960, page 422 and January-February, 1961, pages 51-61.

(2) Data published by the Economic Intelligence Unit of the Indian Institute of Public Opinion, New Delhi, under the title "Corporate Taxation: India, the U.K. and the U.S.A.", January, 1961.

(3) World Tax Series on India and U.K. respectively, by Harvard Law School, Bombay, 1961.

Before analysing the table, it is necessary to write a brief explanatory note on the table. The calculations are made on the basis of the Indian company tax rate of 45 percent. In the U.S.A. a domestic company has to pay a tax at a flat rate of 30 percent on its entire taxable income and a super tax at a rate of 22 percent, i.e. totally 52 percent. In the U.S.A., there is no grossing of the dividends and hence no tax credit is given. In the U.K., a domestic company pays 38.75 percent of its earnings, irrespective of the amount of earnings. It also pays 10 percent of the profits as Profits tax. Thus, a domestic company in the U.K., has to pay a tax of 48.75 percent on its earnings. Dividends in the U.K. are grossed up and a proportionate tax deduction is given.

Further, the calculations are made for a new company which has a total capital of Rs.2 crores out of which Rs.1 crore represents subscribed capital and the remaining amount of Rs.1 crore is loan capital. Furthermore, it is assumed that the capital cost of plant and machinery is Rs.1 crore with other fixed assets of Rs.50 lakhs. The total profits, obtained after making due allowance for general and administrative costs and interest on loan capital, are assumed to be Rs.24 lakhs per year. Though, the

rates of depreciation charges are bound to be different for different companies in India, the U.S.A. and the U.K., it is taken for granted that the rate of depreciation charge is equal to 10 percent of the net fixed assets in all these three countries. The rate of remuneration for management is assumed to be 5 percent of profits before tax. The total burden of company taxation is calculated after taking into account all the deductions and concessions available in these countries. For the sake of convenience, figures regarding depreciation charge, management charge, profits before and after tax and corporate taxes are converted into the percentages of the total profits.

Analysing the table, it becomes clear that the profits after tax in India increase from 35.6 percent in the first year of production to 39.6 percent in the tenth year. The percentage increase in profits in India during the period of ten years is at all levels above the corresponding figures in the U.S.A. The percentage rates of increase in profits in India and the U.K. are almost equal for the first two years of production. In the subsequent years, the U.K. rate of profits falls below the Indian rate of profits.

When the average rate of profit is worked out for the entire period of 10 years, India stands first (38.9

percent), the U.K. stands second (32.6 percent) and the U.S.A. comes last (28.2 percent). Thus, the Indian company tax system confers a substantial advantage over the U.S.A. and the U.K. This advantage accrues mainly due to certain powerful tax concessions such as development rebate, section 15-C and other deductions available in India.

The above discussion makes one thing very clear that it is very difficult to fix an optimum rate of company tax in India or in any other country of the world. Further, it would be rather unwise to overemphasise the significance of tax rate alone as a determinant of profitability or retaining of profits. A tax rate is to be thought of in conjunction with the tax base. Furthermore, the existing company tax system as a whole does not give rise to an unreasonably high burden of taxation, in India.

But, this does not mean that the company tax system as a whole is free from anomalies. There are certain anomalies in the individual taxes such as capital gains tax, bonus shares tax and the tax on inter-corporate dividends. These will have to be eliminated, if the company tax system has to serve the lofty purposes of maximum resource mobilisation and best resource utilisation.

TAX ON CAPITAL GAINS:

The capital gains tax has certain anomalies which are already described in the preceding chapter . Upto 1961-62, while charging the capital gains tax, no reference was made to the investment period. Companies had to pay a capital gains tax at a rate of 30 percent. It was therefore advocated that in view of the fact that the new companies do not start yielding returns in the very short period of time, there should not be one uniform rate of capital gains tax on all types of investments. In the Finance Act of 1962, it has been laid down that the assets disposed of within a period of one year are to be taxed at the usual rates applicable to business profits; while long term capital gains will be charged at the rate of 30 percent.

If it is desired to encourage long term investments in the corporate sector of the economy, special treatment should be given to the long term capital gains which may either be completely tax exempt as in West Germany, Australia and England or taxed at a much lower rate as in some foreign countries.

Further, the capital gains tax exempts capital gains which are passed on through gratuitous transfers.

Experience in the U.S.A. suggests that because of this exemption, nearly one half of the capital gains remain untaxed. It may therefore be suggested that the scope for capital gains to remain untaxed should be narrowed as much as possible.

TAX ON BONUS SHARE:- Though in the Budget for 1961-62, the rate of tax on bonus shares has been reduced from 30 percent to $12\frac{1}{2}$ percent, the adverse effects of the tax are bound to persist. There was some justification for this tax as a measure to prevent avoidance of the excess dividends tax. But, the excess dividends tax is abolished. Therefore, there is no justification for the continuation of a tax on bonus shares. This tax should be abolished at an early date.

TAX ON INTER-CORPORATE DIVIDENDS:- Then would come the problem of inter-corporate dividends taxation. Is this tax a deterrent to inter-corporate investments or not? It is now widely accepted that the inter-corporate investments play a role of crucial importance when they are used by the entrepreneurs to promote new companies. This type of investment has played a dynamic role in the growth of the corporate sectors in America, Japan and Canada. In India, in the past, such investments were utilised by the companies held by the managing agency firms. This gave rise to the evils of financial

oligarchy, monopoly chains and inter-locking of funds. But, during the post-Independence period, the Government has imposed a number of checks to curb the evils of the managing agency system. Therefore, there is now little or no chance of misusing the inter-corporate investments. In other words, the utility of such investments has now increased.

In view of the above, it is suggested that the inter-corporate dividends taxation in India should be reviewed. It will be quite interesting to refer to the experience of some foreign countries in this respect. In the U.K., the inter-corporate dividends do not attract any special income or profits tax. Canada and Newzealand also do not tax the dividends received by a resident company from another resident company. In the U.S.A. only 15 percent of the inter-corporate dividends are taxable. In West Germany, if the investing company owns at least 25 percent of the share capital of the company that pays the dividends, the dividend income of the investing company is exempt from the tax liability.

India has tried to tackle the problem of inter-corporate dividends taxation mainly through Section 56-A whereby companies operating in certain specified priority

industries are exempted from the payment of super tax on dividend income received by them. Upto 1959 when the old scheme of company taxation existed the dividend carried a tax credit according to the system of grossing up the dividends. Thus, the inter-corporate dividends under the two benefits--section 56-A and the tax credit--were almost exempted from tax. But, under the new scheme of company taxation, the system of grossing of dividends is abolished. So, an additional tax burden on section 56-A companies has now emerged.

In the case of other companies the burden of inter-corporate dividends is rather heavy. The double taxation of inter-corporate dividends in fact leads to treble taxation i.e. (1) tax on the first company (2) tax on the receiving company and (3) tax on the shareholders.

Ofcourse, in view of the sizeable revenue yield of Rs.19 crores in 1958-59 and perhaps still larger yields in the subsequent years, it may not be possible to abolish this tax altogether. But, a suitable reduction in the tax rate is necessary.

TAX ON CONTROLLED COMPANIES:- The taxation of section 23-A companies poses rather a complicated problem. One important question connected with this tax is :

should the penal provisions of section 23-A be abolished or not ?

In this connection a reference may be made to the findings of the Taxation Enquiry Commission (1953-54). The Commission found out that out of 3005 private companies, as many as 2589 (i.e. 86 percent) were controlled by four or fewer persons. Out of these, there were 944 companies (i.e. 31.4 percent) in each of which the majority of shares were owned by one shareholder, and 937 companies (i.e. 31.2 percent) in each of which the majority of shares were held by two shareholders. If the analysis is confined to 257 companies with a paid-up capital of more than Rs.5 lakhs, as many as 224 (i.e. 87 percent) were under the control of not more than four persons; out of these, 103 were under the control of one person and 66 were under the control of two persons. The Commission observed a similar trend when it took a sample of 372 companies to find out the percentage of shares held by the largest single shareholder. Therefore, the Commission came to the conclusion that, "the justification of differential treatment to Section 23-A companies rests on the nature of their ownership". (3)

(3) (3) Report of the Taxation Enquiry Commission, 1953-54, Vol. II, pages 177-178.

The Commission also observes that no doubt the controlled companies play an important role in capital formation, they are often misused to evade super tax.

The abovementioned facts clearly show that the private companies are more or less of the type of closely-held companies. It is now an open secret that in a number of such companies, large blocks of shares are held by a group of close relatives. Therefore, it would not be proper to advocate the repeal of section 23-A.

(4)
It has been suggested, however, that a new definition of a company in which the public are interested should be adopted with the specific provisions that Section 23-A would not apply to a company which was not a private company within the meaning of the companies Act and to which shares carrying not less than $33\frac{1}{3}$ percent of the voting power had been allotted unconditionally to or acquired unconditionally and were throughout the previous year beneficially held by the public; and the affairs of the company or the shares carrying more than $66\frac{2}{3}$ percent of the total voting power were at no time during the year controlled or held by less than six persons. This will help excluding those companies which are unnecessarily brought under Section 23-A.

(4) Taxation and Foreign Investment, 1958, by N.C.A.E.R., page 83.

In this connection, it would be quite useful to refer to the views of the Coates Commission which submitted its report on the company tax system of East Africa in May 1957. This Commission recommended that in defining a controlled company the emphasis should be on control (or ownership) rather than on the amount of shareholding held by the public.⁽⁵⁾

If a controlled company is defined in terms of the amount of shareholding held by the public, it may create certain loopholes in the application of this Section. The companies may try to evade Section 23-A by changing the pattern on their shareholdings. Or, they may try to show on paper a particular shareholding pattern which may be quite different from its actual pattern of shareholding. It may also give rise to the wide-spread practice of "benami shareholdings" against which there has been a longstanding complaint in India. Moreover, shareholding may change faster than the control or ownership. Hence, it may become difficult to catch the companies. In short, it would be rather clumsy to redefine Section 23-A in terms of the amount of shareholding by the public.

(5) Coates Commission's Report, 1957, summarised by David Walker in his article, "A Recent change in East African Company Taxation", in Journal of Public Finance, 1960, Vol.XV, No.2, page 173.

The case for repealing Section 23-A can also be ruled out on the basis of the experience of the other countries which have successfully adopted preventive provisions against persons who seek to evade super tax by allowing income to accumulate in a particular type of company. In most of the Western countries, provisions similar to those of Section 23-A do exist, though ofcourse, their provisions are not so harsh as those of the Indian provisions.

From the point of view of equity, there is no reason why few individuals who may float a company should be allowed to save and invest on more favourable terms than other individuals or partnerships. Further, the provisions of this Section do not prevent the companies from saving more and investing more. It only refuses the companies certain special advantages beyond a particular extent. Thus, there seems to be no clear justification for scrapping the provisions of Section 23-A.

TAX ON CORPORATE WEALTH:- Then, the most important question is : is there any scope for the imposition of any new tax on companies ? If yes, should the new tax be levied on the profits or wealth of the companies ? These questions will have to be discussed in the broad

perspective of providing for development finance for the corporate sector and also for the revenue needs of the Government during the period of the Five Year Plans. It is likely that the Government may try to explore more and more sources of income through taxation. At the same time, the expanding corporate sector too may be in need of retaining more and more profits.

The increasing need for retained profits for the expanding corporate sector has been already explained in chapter III. To supplement that discussion, it may be added that during the First Plan Period, industrial production increased by 39 percent. In the Second Plan period, it increased by 40 percent. Though the increase in industrial production during the period of the two plans has been almost equal, there has been a fundamental difference in the method of financing the increase in production. During the First Plan period, production could be increased by tapping the unused capacity of the industries. During the Second Plan period, increase in production had to be financed from fresh capital. In other words, a higher rate of capital formation was needed to finance the increase in industrial production during

the Second Plan period. The Third Plan envisages about 70 percent increase in industrial production. Since 90 percent of the manufacturing industries are in the corporate sector of the economy, there will be greater need of relying on the retained profits.

But, as already pointed out (in chapter III), in the field of Indian corporate finance, a sort of law (or a peculiar trend) seems to be operating: whenever the rate of growth of net fixed assets rises (or falls), the proportion of retained profits falls (or rises). This sort of law seems to have fully operated during the period 1951-60 which covers the period of the two plans. If this law continues to operate in the Third Plan Period too, retained profits are likely to fall.

Whether this law continues to operate or not, one thing is certain that a greater reliance on retained profits as a source of financing the planned expansion of the industrial production will have to be emphasised in future. Keeping this in view, it may be suggested that it would be unwise to levy a new tax or raise the rate of tax on corporate profits. Therefore, an alternative tax will have to be devised to meet the increasing revenue needs of the Government. The wealth tax can serve this

purpose. Ofcourse, this tax has been abolished with effect from 1.4.1960.

On the issue of reimposition of the wealth tax on companies, Mr.Kaldor observes that,"..... considered as an alternative to a higher rate of profits taxation on companies, it has this to be said in its favour that its economic effects are distinctly more favourable than that of the profits tax. For it penalises firms who earn a low rate of profit on the capital which they employ and favours those firms whose earning power is high".⁽⁶⁾ Mr.Kaldor did not recommend a wealth tax on companies in 1956 when he wrote his Report on "Indian Tax Reform". He recommended this tax subsequently in the context of the growing revenue needs of India's development programme. He has rightly emphasised that the wealth tax on companies will certainly reward efficiency and penalise inefficiency. In the present stage of India's economic development, it is quite necessary to provide for special inducements to those companies which are able to utilise more efficiently their resources. It is for this important reason that one has to advocate more of the burden of taxation on

(6) "Tax Reform in India", by Nicholas Kaldor, in Annual Number of Economic Weekly, January, 1958, page 198.

companies in the form of a wealth tax and less in the form of a new tax on profits or a higher rate of tax on profits. Further, the company tax system will be more broad-based if the wealth tax on companies is reimposed.

Against the reimposition of the wealth tax on companies, it may be argued that since this tax does not exist in important capital exporting countries and also in capital importing countries which compete with India for foreign capital, the tax may discourage the flow of foreign capital in India. In this connection, it may be suggested that if at all this tax hinders the flow of foreign capital, there should be differential tax rates such that foreign companies may be charged at a lower rate. This type of differentiation should not be grudged by the Indian companies, since there is already a difference in the basic rates of super tax for Indian and foreign companies.

It can therefore be suggested that if at all the Government wants to tap more sources of revenue in the corporate sector of the economy, it should be done by not levying a new tax on company profits or by raising further the existing rate of tax on company profits, but by reimposing the wealth tax on companies. If necessary,

the rate of wealth tax may be raised from $\frac{1}{2}$ percent that existed upto 1.4.1960, to a higher rate.

REBATE ON RETAINED PROFITS:- In some quarters, it has been argued that when the tax rate has been raised from 45 percent to 50 percent, it will certainly lower the rate of corporate savings, if the companies have to maintain the same rate of dividend distribution. Further, with the abolition of the excess dividends tax, nothing prevents the companies from declaring even higher dividends. This may prove to be a drag on the internal resources of the companies.

Therefore, if the companies are to be encouraged to retain a larger proportion of profits, they should be offered some substantial incentives. A tax rebate on retained profits can very well serve the purpose of inducing the companies to retain more profits. In the past, a rebate of one anna in the rupee on undistributed profits did exist in India. This was withdrawn when the excess dividends tax was levied. Now that this tax exists no longer, the Indian company tax system does not offer any direct incentive for profit retention. This is at present one glaring loophole in the company tax system of the country. It is high time for the reintroduction of a

tax rebate on retained profits. If such a measure has to be really effective, it should not be of a nominal amount. It must be sizeable.

The introduction of a tax rebate, when combined with a tax on company's wealth will serve the purpose of offsetting the disincentive effect of the wealth tax on corporate saving.

In the end, it may be mentioned that there has been ample scope for further simplification and rationalisation of the Indian company tax system on the lines suggested above. This much about the reforms necessary in relation to tax rate. In the next chapter, ^athe/detailed discussion will be made about the necessary reforms in relation to tax base.