CHAPTER XII

SCOPE FOR COMPANY TAX REFORM IN INDIA (PART II)

In the preceding chapter, the discussion veered round the tax reform in relation to the company tax rate and also some individual company taxes. That explains only one part of the problem under discussion. The other equally important part of the problem, namely, tax reform in relation to tax base will be discussed in the present chapter.

DEVELOPMENT REBATE:- The development rebate has been beset with certain restrictions that come in the way of the companies in enjoying the fullest benefit of the rebate.

The Finance Act of 1958 (Section 10) has laid down that in respect of additions to plant and machinery after January 1,1958, 75 percent of the development rebate to be actually allowed should have been debited to the Profit and Loss Account of the relevant previous year and credited to a reserve account. If a company does not do this, it is not allowed to claim the rebate.

It has been argued that this condition is necessary to prevent the companies from dissipating the amount of rebate. It compels the companies to retain it. But, in view of the fact that the newly installed plant and

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machinery would not, and usually does not, begin to earn profits in the very year of installation, it would be rather unjust to strain the year's profits with an amount of development rebate on new plant and machinery that may not have contributed to the earning of these profits.

This provision can also be criticised on the ground that if the Income tax officer has permitted a larger amount of rebate than is estimated by the company, for the purpose of debiting to Profit and Loss Account, by reason of certain expenses on replacement being treated as capital, or by reason of development rebate on certain additions claimed in an earlier year not having been then allowed on the ground that the machinery came into operation only later, or for any other reason, conceivably the amount of rebate debited to the Profit and Loss Account may fall short of the prescribed amount of 75 percent. In such cases, will the "pro rata" development rebate be permissible to the company, or no rebate will be available at all ? Neither Section 10 of the Finance Act of 1958 clarifies this, nor the Central Board of Revenue has issued any instructions in this regard. Therefore, it may be suggested that Section 10 of the

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Finance Act of 1958 should be completely recast so as to eliminate the loopholes indicated above.

Another restriction introduced by the Finance Act of 1958 is that if the plant and machinery is sold or otherwise transferred to a person other than the Government before ten years from the end of the year of installation, development rebate previously allowed would be withdrawn. This is regarded as a stringent restriction. The words in the Act are "sold or transferred". This may cover all modes of transfers such as mortgage, exchange etc., and in fact it would cover all forms of transfer under which ownership of or title to the asset is alienated permanently or temporarily. The only transfer permitted is to the Government. Therefore, if a firm's business is converted into a company or if the business of a company is transferred to another company through amalgamation, conceivably the rebate would be forfeited. Further, the ten-year period is considered rather long in view of the rapidly changing technology. This provision is said to prevent the application of the latest technology and thereby the programme of modernisation. Ofcourse, there arises the other question whether an underdeveloped country like India should keep abreast of the latest technology

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or it should make use of the scarce capital in whatever form it exists.

There are however some aspects of the ten-year rule which could still be reviewed. Suppose, in a plant, a heavy part is damaged and needs urgent replacement. The damaged part will have to be retained by the company until the ten-year limit is crossed or else the company will have to surrender the benefit of the rebate. Therefore, this provision of clause (VI a) of the Finance Act of 1958 should be relaxed.

The recent amendment of the provision relating to development rebate in the event of amalgamation is also defective as it gives relief only in the case of amalgamation of two companies by forming a new company. In actual practice, the schemes of absorption generally involve absorption of one company by another i.e. there is one liquidation and no formation, whereas the relief in regard to development rebate is available only if there are two liquidations and one formation. This defect could suitably be rectified.

TAX HOLIDAY:- Under Section 15-C company profits or gains from any industrial undertaking, upto 6 percent of "total capital employed" in the undertaking are exempted from

income tax and super tax in the first five years of operation. This prevision has proved to be a dead letter in the sense that most companies are not able to fully avail themselves of this tax holiday. This happens because there is no provision for carry forward.

The Taxation Enquiry Commission (1953-54, Vol. II, page 101) examined the working of Section 15-C and emphasised the ineffectiveness of it, on the ground that the grant of the initial allowance and the additional depreciation allowance absorbed almost the whole of the gross income of the new industries and left no taxable income against which the advantage of the tax holiday could be obtained. Ofcourse, at present, the initial and the additional depreciation allowances do not exist. Instead there is the development rebate and still the companies might not be able to fully avail of Section 15-C benefit.

In order to make this Section fully effective, there should be a provision that it would apply either for five years after a company begins to make assessable profits or, alternatively, during a period extending, say, from the seventh year to the twelfth year of its working. Or, no time limit may be prescribed and it may be laid

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down that income tax and super tax would not be payable on the initial assessable profits of a new industrial undertaking equal to a total of, say, 30 percent of its invested capital.

One more practical suggestion could be given. Under Section 15-C, if any old assets are used for the new unit, the company may lose the entire exemption. So, it is necessary to provide that in the expansion programme, if a company has used old assets to a reasonably small extent to effect economy and saving of foreign exchange, the company should not be deprived of the tax holiday benefit.

DEPRECIATION ALLOWANCE SYSTEM:- No doubt, the existing system of depreciation allowance is quite liberal; but, this system is not yet assigned its proper role in the tax system of the country. The important question about the system is : what should be the role of the depreciation system as an instrument of Government control ?

If a country wants to evolve a "development Oriented depreciation system", it will have to change the age-old role of depreciation merely as a "relief measure". The depreciation allowance is also known as "capital consumption allowance" implying thereby its old good motto of serving the purpose of a "compensatory allowance"— a

compensation for the consumption of the capital assets. The depreciation system of this type may be able to confer on the companies a sort of tax free loan for a period of time. But, it may not be able to play a dynamic role of not only strengthening and stabilising the internal resources of the companies but also regulating or controll -ing ~~ex~~ investment and expansion of the corporate sector of the economy. "A development oriented depreciation system" should not only strengthen and stabilise the internal resources which form only a part of the total corporate finances, but also it should serve some more important purposes such as : regulating or controlling the whole of the corporate investments in such a way that the corporate sector may be able to combat the fluctu-ations of boom or depression; eliminating the chances of nullifying a tax advantage granted under the scheme of tax holidays.

It is high time for India to revise her depre-ciation system in relation to the perspective of long period development of the corporate sector of the economy. Accepting that India should necessarily work out a develop -ment oriented depreciation system, some important questions that may arise are:has India to learn something about the

depreciation systems of some foreign countries which have succeeded in this matter ? What type of reform could be introduced in the Indian depreciation system so as to achieve this goal ? For a proper answer to these questions, it would be necessary to discuss briefly the experience of some of the countries which have successfully tried and tested a simple, liberal, variable depreciation system.

France, Denmark and Sweden have successfully made use of flexible and liberal depreciation systems. The optional system in France permits the historic cost and the depreciation allowances to be multiplied by an index factor fixed annually by the Revenue Authorities to bring the cost and allowances in line with current values. For instance, the index in 1955 for a capital investment made in 1950 was 1.1; for one made in 1949, it was 1.5 and 1.4 for one made in 1914. Further, in France plant, equipment and tools acquired after 1950, and having a normal life exceeding 5 years and which are used in manufacturing, processing, handling or transport are given double the normal annual allowance for the year of acquisition.

In Denmark, 50 percent of the cost of an asset is allowed to be written-off over the agreed normal

life; and 50 percent over the first three years. Since September, 1957, machinery and plant are not allowed to be depreciated at a rate greater than 30 percent of each year's written down value.

Sweden has been unique in giving the company complete freedom in the matter of determining the "life" of an asset, except for the fact that the asset values for tax purposes were limited to those adopted in the company's own books.This limitation aims at preventing the companies from making an unlimited distribution of tax gains; this limitation is also meant to encourage an increased plough-back to cover a more rapid growth.

"The high degree of flexibility produced by Sweden's depreciation system is singular and calls for special comment"(1). Of all the depreciation experiments, that of Sweden is by far the most challenging. The depreciation experiments of Sweden began as early as 1938 when Sweden adopted the "free depreciation" policy under which companies could write off machinery and equipment for tax purposes as they saw fit. The entire cost could be written-off as an expense in the year of acquisition, or on any other basis the companies thought appropriate. For instance, the companies could decide on 10 percent in one year,

(1) "Taxation in the Proposed European Free Trade Area" by Federation of British Industries, London,Second Edition, 1958, page:10.

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30 percent the next year, more in good years and less in bad years, all at the discretion of the companies.

This system has been subject to two restrictions : depreciation for tax purposes in any year should necessarily coincide with depreciation taken on the books for that year; and in no case could total depreciation exceed original cost.

Despite these two restrictions, the free depreciation system has brought forth two salutory effects. First, the conflicts between tax payers and tax authorities about the useful life of assets has been avoided. Second, companies are able to build up adequate reserves which can contribute to a depression resistant economy.

During the post-war boom period, Sweden experienced that the free depreciation system proved to be inflationary. The combination of high tax rates and high profits induced some companies to acquire "depreciation objects". Capital items were purchased in order to increase depreciation allowances rather than for ordinary business reasons. This, in turn, led to increased corporate spending and to more inflation at a time when the problem was to keep capital expenditures within the limits of available resources. Thus, when free depreciation system was

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found to be a mixed blessing, it was replaced by what is called "book depreciation" system in 1956.

Under the book depreciation system, a company can deduct for tax purposes in any year whatever amount of depreciation the company may choose to write off on its books for the year, provided that it does not exceed the limit imposed by the higher of the two statutory ceilings.

The first ceiling provides that depreciation in any year may not exceed 30% of the year-end book value of machinery and equipment. This may enable a company to write off over half the cost of machinery in two years, 30% of 100 in the first year and 30% of the balance of 70 in the second year making a two year total of 51%. This is ofcourse a ceiling. Subject to the 30% ceiling, the amount a company writes off is entirely left to its own discretion. Thus, a large degree of flexibility is still maintained.

Additional flexibility is provided by a supplementary rule. Regardless of the ceiling imposed by the 30% declining balance rule, a tax paying company may, at any time, take a deduction large enough to reduce the book value of his entire stock of machinery and equipment to a figure equal to its total cost, minus the

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cumulative depreciation thereon at the straight line rate of 20% per annum. Under this rule, the tax payer may write off the cost of his machinery and equipment in five years at the most.

In any particular year, the company may avail of the 30% declining balance rule, or the supplementary 20% straight line rule, as the company sees fit. Once the company chooses a particular method in a particular year, that particular method has to be applied to the company's entire stock of machinery for that year. That means the company cannot use one rule for the remaining items. However, in every case, tax depreciation must coincide with book depreciation. With a five year write off available, original cost rather than replacement value remains the depreciation base.

As for the merits of this system, it should be mentioned that it has unique flexibility and also liberality. How and when a company writes off its machinery is left to its discretion, subject to liberal ceiling provisions. "It seems fair to suggest that the Swedish depreciation system does encourage plant modernisation, greatly reduces the problem of rising replacement costs by permitting fast write offs, and eliminates arguments between

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tax payers and tax authorities about useful life" (2).

The Swedish tax system can boast not only of its depreciation system but also of a system of tax free investment reserves. It was in 1938 that for the first time on provision basis, laws were enacted to allow the Swedish companies to make tax free allocations to reserves for future investment. In 1947, they were made permanent and were greatly widened in scope in 1955. In 1959, further amendments were made to provide for investment incentives.

Under this scheme, a company, can allocate, at its own discretion, an amount upto 40% of its pretax income to an investment reserve for economic stabilisation. There is no ceiling on the total amount which a reserve may reach, or on the total number of years in which an allocation to the reserve may be made. While there is no necessity of government permission to make the deductible allocation to the reserve, control over the tax payer's use of his reserve is largely in the hands of the Labour Market Board whose primary duty is to combat unemployment. The Board may authorise a company to

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(2) Taxation and Stability", by Martin Norr, in Harvard Business Review, Vol.38, January-February, 1960, page 54.

use all or part of its investment reserve for one of the purposes allowed by the government, after taking into account the country's economic and employment situation. When an investment reserve is utilised for one of the purposes, say, for construction, machines, equipment etc., the amount so utilised is not restored to taxable income. But, to avoid double deductions, the asset or expense charged to the reserve is, to the extent so charged, not also subject to depreciation or deduction.

As an inducement for the use of investment reserves, a company using all or part of a reserve with the permission of the Labour Market Board, receives, in the year of use, an extra "investment deduction" from taxable income equal to 10% of the amount used. If a reserve is used without the permission of the Board, the amount of reserve in question plus a penalty sum equal to 10% of the amount is added to taxable income.

But, there is one exception to this rule. After five years from the time an allocation to the reserve has been made, the tax-payer may withdraw upto 30% of that sum from the reserve without government permission. However, in that case, the tax payer does not receive the extra 10% investment deduction.

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Thus, the company may disregard the government's control but only at the expense of losing certain tax advantages and incurring certain tax penalties.

What has been the actual effect of the use of investment reserves in Sweden ? Significantly, in Sweden, private industrial investment has increased substantially. Sweden's experience clearly indicates that a tax policy can enlist private capital to fight against recession and unemployment. To the extent that private spending can be increased or decreased, the pressure on government spending may be relieved.

Though Swedish system has proved its feasibility, the British Royal Commission (1955) argues that the "free depreciation" suffers from two serious objections which affect its whole purpose. First, the taxing authority surrenders control over the yield of the tax. Second, the taxing authority also surrenders the power to attempt to influence investment by varying the initial allowance rates.(3) The objections by the Commission are based on the view that there is not enough evidence to infer that the results achieved by free or variable depreciation are worthwhile. The Commission also believes that after all

(3) Report of the Royal Commission on Taxation of Profits and Income, 1955, para 373, page 116.

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free depreciation is only an extreme form of initial allowance and that a trial of reasonable duration would be necessary to see if it helps to give the enterprising firm confidence in a policy of expansion.

Against the views of the British Royal Commission (1955), Mr.R.F.Harrod[4] points out that the investment allowance advocated by the Commission and adopted by Great Britain is wasteful of public money, since it subsidizes all investment including replacement, the vast majority of which is nothing but normal replacement of old worn-out machines, which would take place in any case. Mr.Harrod suggests the adoption of the Swedish type of depreciation system, including the provision that the amounts chosen by the tax payer for the depreciation of his assets must also be those used in the firm's books. The auditor would be required by the tax authorities to provide a certificate that the company had in fact written the equipment off in its own Profit and Loss account at the same rate as that at which it was claiming its depreciation allowance on tax. It might also be useful to require that tax relief be set aside in a distinct reserve account for replacements. Thus, Mr.Harrod

(4) "Encouraging Selective Investment", by R.F.Harrod, in the Director, Vol.IX, June, 1957, page 489.

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upholds Swedish system of depreciation with, ofcourse, some modifications.

In assessing the possibility of adopting the Swedish system, the effect of the balancing allowances should also be taken into account. In Great Britain as also in India when a plant is scrapped, that part of the difference between the new and the scrap or second hand price which has not been allowed as depreciation is set off for tax purposes as a "balancing allowance". The difference between this system and one of "unrestricted (or free) write off" is simply one of timing, and consequently involves the interest on tax payments. Under both systems, a company can scrap when it wants, and get the full tax allowance by the time it replaces the plant; but under the Swedish system, it can get the allowance in advance of scrapping. However, the Swedish system gives an accounting profit, if after getting full allowances, the company gets a high second-hand price. If such a price is above the written-down value, for tax purposes, the difference will be "charged" and added to the profits figure in the next accounting period, whether the asset is replaced or not. In England and also in India, these chargeable profits are limited to the allowances already

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received. The balance of profits in such a transaction is treated in India as capital gain and taxed accordingly.

However, it should be remembered that these balancing allowances apply only where plant is scrapped and replaced by a similar asset. They do not cover the expanding companies which may wish to retain plant in production and at the same time to get it written off as soon as possible, nor the case where the manufacture of one product is abandoned in favour of another requiring a radically different plant.

The question which may still be raised is : what will be the cost of the flexible depreciation allowances to the exchequer ? Mr.R.F.Harrod believes that in the long run, unlike the investment allowances, the free depreciation system would cost the exchequer nothing. However, surely there will be the interest loss to the Government due to the delayed payment of tax; but, this may not be equal to the total sum gained by the tax payer, since it is a reasonable assumption that the interest or discount gained by the tax payer by the delayed tax payment (either through initial or other accelerated allowances) would itself attract income or profits tax.

From the above discussion, it becomes clear that the Swedish system of depreciation policy has some unique

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features which mark the superiority of this system over other systems. With its liberality and flexibility, it may have some important lessons for a country like India whose depreciation system in particular and corporate tax system in general are not yet fully attuned to development purposes.

Has India to learn something about depreciation from the Swedish depreciation system ? Can Indian depreciation rules be revised to encourage modernisation and promote investment ? No doubt, the existing provisions of depreciation allowances in India are generous and provide for an incentive to investment. But, they actually result in a smaller depreciation allowance in the latter part of the life of an asset. Development rebate and tax holidays are also provided for in India's corporate tax system. But, they lack flexibility. India has yet to develop the development oriented depreciation system.

In India, rationalisation or modernisation has been a crying need of the day. Mainly due to financial difficulties, the desirable degree of rationalisation has not yet been achieved. Depreciation policy of the Swedish type, with suitable modifications will certainly help

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the expanding companies to plan for modernisation. It would be reasonable to assume that a better atmosphere of confidence would be created if new depreciation measures were introduced in India, with a reasonable guarantee of their continuity, thus allowing for forward planning. Assuming that in India, economic development is necessary and desirable, that it should include the development of new corporations and that the tax policy should be oriented towards these ends, it should be suggested that a leaf should be taken out of the Swedish book on depreciation policy. In the beginning, this policy may be implemented in the case of nationally important industries or industries which are given top priority under the Five Year Plans. Later on, it could be extended to other industries as well eventhough the depreciation system may not be so liberally applied in their case.

The various reforms proposed in this study should, it is hoped, give the Indian company tax system the required development orientation and as a result the corporate sector might be encouraged to play a more important role in raising the level of economic activity in the country.