CHAPTER IV

JUSTIFICATION OF CORPORATE TAXATION

There are two important questions with respect to corporate taxation: "Why should corporations be taxed?" and "How should corporations be taxed?". The first question which is about the justification of corporate taxation will be discussed in this chapter. The second question which has a bearing on the corporate tax structure, corporate tax problems and policy will be dealt with in the next chapter.

Justification of taxation can be studied in its two aspects. On the positive side, there are arguments for corporate taxation. On the negative side, there are arguments which do not favour levying of taxes on corporations. For a logical discussion of these two types of arguments, it would be necessary to study them together instead of discussing them in two isolated broad groups. For instance, an argument not in favour of corporate taxation can best be refuted by an argument of the positive side.

From a purely academic or theoretical standpoint, the arguments against the corporate taxes are imposing and impressive. First, it has been often contended that the corporate tax would lead to "double taxation". Second, an important objection against the corporate tax is that it would raise the price of the goods and /or lower the wages of labourers. This would certainly go against the welfare of consumers and wage earners. Third, it has been pointed out that a corporate tax is likely to bring a revenue loss to the government. Because, if there is no tax on a portion of the corporate income which is, at present, taken away by the government in the form of a tax, that portion of the corporate income would be mostly distributed in the form of dividends much of which would fall in the upper income brackets and would therefore produce additional tax revenue. Fourth, it is argued that a corporation is a piece of contract paper and one cannot tax a piece of contract paper. Fifth, to the extent that the tax is not immediately shifted, it may reduce the net return from the capital invested. This may adversely affect the capital investment and expansion of the corporate sector of the economy; it may also unfavourably affect the methods of corporate financing, corporate organisation and consolidation. It will be quite interesting to examine these arguments one by one.

The first argument that the corporate tax system, if not worked out on the basis of partnership approach, is bound to lead to double taxation, is based on a confusion about the concept of double taxation and nature of the problems of double taxation. There are in reality no less than five different forms of double taxation. These in short may be mentioned as: (1) Double taxation of property and of debts, or of income and interest on debts. (2) Double taxation of property and of income. (3) Double taxation of property and of stock. (4) Double taxation arising from conflicts of jurisdiction. (5) Double taxation of the corporation and of the holders of stock or bonds.

These five forms of double taxation in general imply that if the same property or a part of property, the same income or a part of income and the same corporation under two overlapping jurisdictions, are taxed twice, double taxation is said to arise. Double taxation is also said to arise in the case of inter-corporate dividends. But, in recent years, double taxation, in the popular sense of the term, is said to arise if corporations have to pay a tax on their profits and when these profits are distributed in the form of dividends to shareholders, again on the same amount, the shareholders have to pay a personal income tax. In short, double taxation takes place when the same income is taxed twice, first in the hands of a corporation and second in the hands of a shareholder.

But, conceptually "double taxation" does not and should not mean simultaneous imposition of two taxes on the same person or property or income or institution. It really means whether or not the taxation of corporate profits and shareholder's dividends compare with the taxation of other kinds of incoéme and other income recépients. In this sense, the term "double taxation" should be replaced by terms such as "relative overtaxation" or "relative undertaxation". It is unfortunate that the emotional content of the words "double taxation" has not been properly realised by all those who advocate abolishing taxation on corporations. Instead of talking about the removal of "double taxation", it would be better to speak of relatively equalising taxes on corporate profits and other kinds of income. "What is necessary is not so much of eliminating "double taxation" in the literal sense as of equalising taxes on different kinds of income".(1)

Against the taxation of corporate profits, it has also been argued that this system is inequitable. Because, there is a difference of tax treatment between a corporation and an individual. In the words of the British Royal Commission on Taxation of Profits and Income,(1955),"the most conspicuous feature of distinction is the levying of a profits tax which is not charged upon the business profits of individuals but is charged upon the business profits of corporation."(2) All those who believe that the factor of crucial importance in determining the appropriate tax treatment of a given amount of income is

(1) "The Post-war Corporation Tax Structure" by Richard Goode in "How should corporations be taxed",1946,by Tax Institute, page 47.

(2) Report of the Royal Commission on the Taxation of Profits and Income (1955), page 13.

ownership by an individual possessing total resources of a particular amount and with his own peculiar personal circumstances, argue that a company is nothing but an aggregate of a number of shareholders who have come together for a common purpose under limited liability. Therefore, the profits earned by a company should become liable to tax only when the profits fall into the personal incomes of shareholders by way of dividend. The flaw in this argument lies in the fact that it is ignored that a company is clothed with a legal personality of its own and hence it is an entity distinct from its shareholders. The assumption that a company is a separate legal person is a more important consideration than the fact that its income is no more than the income from the joint-stock of certain individuals. So, it may be contended that a company should bear income tax on its profits and its shareholders should bear income tax on their dividends as a separate matter.

Moreover, the criticism against the corporate profit taxation can be ruled out if the first principle of equity is properly understood. The first principle of equity in taxation is often held to be to tax all natural persons with the same income at the same rate. But, this principle of equal taxation of equal incomes is subject to modification in accordance with the principle of reasonable classification of incomes, sources of incomes, nature of income and income recipients. It may be pointed out that the differences in the tax rates or tax levels on shareholders and other income recipients may be a fair reflection of genuine differences between incomes of shareholders and incomes of others. Further, the taxation of both the incomes should be thought of not merely in terms of rates, but in terms of its overall effects on distribution of income and wealth, on saving and consumption, on investment and incentives and also on employment and national income.

Particularly, double taxation of corporate profits and shareholders' dividends has also practical reasons. In all those countries of the West where confederation of the States took place, the taxing authorities of the States realised that if only the shareholders of the local corporations were taxed, it would amount to taxing only a part of the total corporate income which was distributed to the shareholders resident of the State. On the other hand, taxation of a corporation as a legal entity was profitable only to the State in which the corporation was organised and thus it was not of much economic benefit to the States of residence of the shareholders.

Thus, the double taxation argument sounds illogical and impractical. Not only that, but it would be better to use "over or under-taxation" instead of "double taxation" the of income or institution or person or property.

The second argument that a tax on a corporation can be shifted forward or backward and hence it would raise the price and/or lower the wage, can be regarded only as half truth. Half truth, because there is no perfect refutation to the contention of forward or backward shifting of the corporate tax. To refute this contention, one has to resort to the traditional theory of tax incidence. But, then, the traditional theory itself has become the target of criticism under the influence of new theory of tax incidence which supports the contention of forward or backward shifting of the tax. Also there are findings of some surveys conducted with a view to ascertaining the possibility of tax shifting. Therefore, a thorough analysis of all these theories and surveys will be necessary for the purpose.

The traditional theory which is also known as "micro-economic theory" of tax shifting assumes the existence of perfect competition (or monopoly). It states that producers, irrespective of whether there is perfect competition or monopol will try to fix their prices and output so as to achieve their goal of profit maximisation. A charge on those profits cannot therefore affect the price or output at which their profits are maximised.

For a competitive enterprise, the argument rests on the role of marginal or no-profit corporations in the pricing process. In virtually all lines of activity, it is said, there are some corporations that do not earn any profits. Therefore they are not subject to tax. Since the contribution of these marginal firms to total supply is necessary to meet the demand, price must be high enough to cover their costs. Since these corporations do not pay any tax, there is no possibility of shifting the tax forward in the form of higher prices.

In the case of a monopoly, it can be argued that the corporate tax cannot be shifted, since price was presumably fixed at the point of maximum returns prior to the imposition of the tax. If this condition is met, no change in price is possible after the effective date of the tax that will compensate the monopolist for the tax imposed, but not for the same reason as in a competitive enterprise.

Therefore, the traditional theory draws a conclusion that a corporate tax cannot be shifted forward in the form of higher price. This traditional theory of corporate tax shifting got inductive verifications by a number of economists who undertook fact-finding surveys to assess the validity of this theory. For instance, the National Industrial Conference Board of America published two volumes on this problem as early as in 1928-30, the main conclusion of which is that, "the consideration of the nature of the tax, the theory of market prices, the statistical analysis of corporation costs and profits and the opinions and practices of business men, all confirm the conclusion that the federal corporation income tax is not shifted by manufacturing and mercantile business, except under rare circumstances." (3)

A somewhat similar study in England pointed to the conclusion that the British income tax was not shifted by the business corporations. (4)

But, recently this theory is severely criticised on the grounds that it is based on unrealistic assumptions, that it unduly emphasises the role of marginal firm and ignores the role of the representative firm, that the theory makes a confusion between the economic costs and costs allowable for tax purposes. All these points of criticism have paved the way for a new theory of tax shifting.

According to the new theory, the corporate income tax tends to be reflected in prices and is actually passed on to consumers to a much greater extent than is commonly supposed. This theory rests partly on the fact that the prices are administered in the manufacturing corporations. The process by which administered prices are determined is

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(3) "The Shifting and Effects of the Federal Corporation Income tax" 2 Vols (1928-30), Vol.I, page 157, by the National Industrial Conference Board of America.

(4) W.H.Coates' Memorandum to the Report on "The incidence of Income tax", by the Committee on National Debt and Taxation (1927), App.11.

practically the opposite of that assumed by the traditional theory of incidence. An administered price is one that is fixed by management after a careful survey of all factors involved— the expected demand, the cost of production and of selling, the price of similar articles, the general price level, the pricing policies of the concern and its position in the trade. In other words,(prices are fixed in advance of production on the basis of cost schedules and estimates of probable demand etc. The prices thus fixed are adhered to for periods of varying length, depending upon trends in costs, the competition that has to be met and other market factors. In some cases, prices are fixed by some leading firms; other firms merely follow the leaders.)

In fixing the administered prices, all costs and charges at varying levels of output, including a fair return on equity capital are taken into account. In order to ensure a fair return on equity capital, the income taxes likely to be levied on corporate profits must be taken into account.

One important assumption on which this theory is based is that the corporations which fix the administered price do not generally follow the goal of maximising profits. What guides them in determining the administered prices is satisfactory or normal profits and not maximum profits. The implication is that the administered price is fixed at a bit low level so that over a period of time, a corporation may be able to maximise the profits.

However, the new theory does not advocate that a corporate income tax or a rise in the tax rate can always be shifted under all circumstances. It depends on the nature of demand for the products of the corporation, the rate of tax, the nature of the capital structure and the ratio of sales to taxable income. In the case of capital structure, the higher the ratio of preferred dividends to profits, the more likely is a corporation to attempt to pass on a given tax increase. "In the case of the ratio of sales to taxable income, it can be said that the more frequent the turnover of the equity capital employed, the smaller will be the increase in price required to recoup the tax".(5) This ratio is significant in all cases where demand shows a high degree of elasticity.

Since the traditional and the new theories of tax shifting represent the economists' point of view and not the businessmen's point of view, the National Industrial Board of America undertook in 1948 a survey to find out whether or not the sharp increase in the tax rates on corporations during the post-war period had any influence on their price

(5) "Incidence of the corporation Income Tax:Capital Structure and Turnover Rates", by Carl Shoup, in National Tax Journal, Vol.I, March, 1948, page 15.

policies. The questionnaire was addressed to 1000 manufacturing corporations. The question of great importance put to them was: "Has the corporate income tax consciously influenced your pricing policies ?". Of the 209 corporations which gave specific and factual replies to this question, as many as 125 i.e. 60 percent of these corporations replied in the affirmative. Whereas, the remaining 84 i.e. 40 percent replied in the negative. Further, three fifth of the 1000 corporations replied that they took the corporate income tax into account in determining the prices. This shows that there may be a strong tendency to recoup the tax, if it is possible.(6)

The three points of view put forth by the traditional theory, the new theory and the businessmen make one thing very clear. It is not always possible to set definite limits to the actual extent of the relative overtaxation of corporate profits. Because, it is difficult to know with certainty who actually pays the present corporate taxes.

Even if it is assumed that the corporate tax is shifted forward or backward, it does not suggest that there should be no tax on shareholders. Shifting forward will in effect be a broad consumption tax and must be so apprised.

(6) "The Shifting and Effects of the Federal Corporation Income Tax", 1948, pages 236-38, by National Industrial Conference Board of America.

Further even if a tax is shifted forward or backward, the shareholders deserve no tax relief at all. The basis of this assertion is the familiar theory of capitalisation and amortisation. If present shareholders bought their shares with the expectation that the corporate tax would continue, they probably took the tax into account in deciding how much to pay for shares. Probably, share prices decreased or did not rise as much as they otherwise would have. It is likely that the present shareholders might have bought their shares at prices and yields which at least in part discounted the tax. To the extent that they did so, the corporate tax was transformed into a one time levy on the previous owners of shares, and its unexpected repeal or reduction would give the present shareholders windfall gains. It is for this reason that Mr.Kaldor in his book on "An Expenditure Tax" has expressed the view that, "company taxation, then, appears as a highly effective method of taxing the benefits accruing to shareholders as a group in the form of capital gains or of compensating for the differential advantages which the group of ordinary shareholders obtain at the expense of other classes of property-owners during a period of inflation."(7)

Again, all those who do not favour a tax on corporations should remember that taxation is not the only factor

(7) "An Expenditure Tax", 1955, N.Kaldor, Ch.V.,page 163.

influencing prices and wages. High prices, low wages and large profits are as much dependent on the volume of production, technological and managerial improvement as on a tax policy.

Moreover, if the corporations are already passing on the income tax to their consumers in the form of higher prices or as lower wages to their employees, the argument for tax relief or tax abolition on corporate profits has no validity at all. Because, corporate profits after taxes would remain the same as they would have been without a corporation tax.

The above discussion shows that the traditional theory and the new theory are in sharp conflict. Whereas, from the point of view of the businessmen, corporate tax does influence either directly or indirectly their price policites. It should be admitted that there is no perfect refutation to the argument that corporation tax will lead to raising of prices and/or lowering of wages. The chief merit of the new theory lies in that it does not hold that the corporate tax is always reflected in price. Rather the theory holds that this tax tends to be reflected in price and may be completely shifted in some circumstances.

3 The third main argument that the portion of the corporate income which is, at present, taken away by the government in the form of tax would be mostly paid out in

dividends, much of which would fall in the upper income brackets and would therefore produce additional tax-revenue can be easily refuted in two ways. Firstly, in the absence of the corporate taxes, shareholders could postpone or even escape personal taxes on their part of undistributed profits. With the present low rates on long term capital gains in India, such an opportunity for tax avoidance would be especially tempting. Secondly, the action of not taxing the undistributed profits of a corporation may lead to certain marked inequities. The individual proprietor of a business is liable to be assessed on the whole of the profits earned by him irrespective of how much of them he may retain for the purpose of strengthening and expanding his undertaking. This treatment would be in sharp contrast to the untaxed growth in wealth that would take place if a corporation is permitted a tax exemption in respect of its undistributed profits. Further, the growth of untaxed wealth would be accompanied by an increase in the capital value of the shares of a corporation and thus it would serve as a striking instance of amounts of capital being built up out of untaxed income. Obvisouly, the argument for the outright tax exemption must be rejected. Because, the fact remains that the profits of a corporation are derived from the employment of the wealth of individual shareholders, and the real problem is to relate the taxation of the profits of a corporation at the undistributed stage to the general scheme of progressive taxation of personal incomes, bearing in mind that distributions when they take place in dividend form fall under the progressive system.

The fourth argument is that a corporation is merely a piece of contract paper and hence it would be unjust to tax a piece of paper. This argument is advanced by the proponents of the "contract theory" of corporation, according to which the simplest concept of corporation is to regard it as a contractual arrangement between certain persons for the pursuit of common ends. This theory is already discussed in chapter I.

The opponents of the contract theory contend that a corporation is something more than a mere piece of paper. Corporations are legal persons created by the State which confers on them certain privileges and duties. So, this is known as "Sovereignty theory" of corporation which is also described in Chapter I. According to this theory a corporation tax is of the nature of a privilege tax.

Against this contention, the contract theorists argue:what exactly is the tax argument in the sovereignty theory ? If the corporation tax is a privilege tax, should corporations not demand a correspondence between the privileges enjoyed by them and taxes payable ? The critics further argue that it is illegitimate to treat a corporation tax as a tax on the privileges or right of incorporation. In no country of the world, taxes are imposed on the basis of rights or privileges. If taxes are to be imposed on the basis of privileges enjoyed by corporations, the taxing authority should scientifically arrange all such privileges in a heirarchical order and then on the most important privileges, heaviest taxes should be imposed by the tax authority. Further, if it is a privilege tax, it can be justified if it is levied only when the privilege is granted, that is, when a company is incorporated. Whereas, the present day corporate taxes bear no relationship to the number and types of privileges granted.

To this criticism, the sovereignty theorists reply that even if corporation tax is not regarded as a privilege tax, it should be admitted that it is as a result of the direct effect of these privileges that a corporation is able to acquire permanent character. "This concept of permanence of corporations vs. non-permanence of individuals has played a great role in European tax legislation".(8) Since corporations

(8) "Corporate Tax Problems", 1958, U.N.Economic and Social Council, page 47.

with their permanent character are exempt from the death taxation, an alternative tax on them is perfectly justified.

Furthermore, the sovereignty theorists point out that while distinguishing between an income tax and corporation tax, it should be remembered that income tax is a tax on natural individuals. So, it is to be levied according to one's ability to pay so that ultimately the economic welfare of the whole society may be maximised. Whereas, while taxing a corporation, the problem of maximising the economic welfare does not arise, as the corporation is a legal person created by the State. Therefore it is not necessary to fix the rates of corporation taxes so as to conform to the principle of ability to pay or to the type and number of privileges granted by the State.

To resolve this controversy, the Taxation Enquiry Committee (1924-25) arrived at a compromise view that, "its justification lies partly in the fact that companies derive certain advantages and enjoy certain privileges as a result of incorporation, and partly in the fact that that portion of the profits of companies which is not distributed as dividends, but is placed to reserves, escapes assessment to super tax."(9)

Then comes the last argument that the corporate

(9) Report of the Taxation Enquiry Committee (1924-25), page 251.

tax may adversely affect the investment. The argument rests on the belief that to the extent that tax is not shifted, the amount of retained profits for expansion may be reduced. Or a part of the tax would be borne by shareholders who may receive reduced dividends, and a part of tax may be reflected in the reduction of the internal funds available for investment. In other words, a corporate tax may spoil the prospects of internal financing and may compel a corporation to resort to external financing which may not be always desirable. Such a tax effect is likely to be felt particularly by the new and growing corporations.

Also, a corollary of the above argument is used to oppose corporate taxes. It is contended that the tax may reduce the incentives of the managers to undertake expansion. Because a tax reduces the net return which will be available to a corporation as a result of expansion, some marginal projects may be abondoned.

Against these arguments, it can be pointed out that the adverse effects mentioned above may arise due to any tax on the earnings of any form of business organisation, let alone the corporate form of business organisation. Even the taxes on salaries and wages may hamper upon investment.

Also, the investment effect argument ignores that one of the important functions of a tax on a business enterprise is to curtail private spending in order to mobilise resources for the public sector of the e conomy. The public sector which works for larger socio-economic goals should be given first preference for resource availability. It has been now increasingly agreed that taxation can be ~~effixt~~ effectively used as a tool of fiscal policy. If there exists inflation, the additional purchasing power can be mopped up through taxation. During t he depression period, the taxing authority will have to encourage expansion and strengthening of the economy either through tax reliefs or tax holidays. Therefore, while analysing the effects of corporate taxation on investment and incentive for expansion, it would be better to keep in view the "macro-approach" i.e. investment and expansion of the economy as a whole.

The macro approach will have a greater relevance in a country like India where taxation has to play a dynamic role of transferring corporate resources from the private sector where they might be largely consumed away or where they might be kept idle to escape taxation, to the public sector where they will be used according to the national priorities and largely for a higher rate of capital formation.

Therefore, there is more than enough justification of corporate taxation. Now corporate taxation has come to stay. In most of the progressive countries of the world,

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corporate taxation has occupied an important position in their tax structures. Though the five main arguments and counter-arguments are discussed in the context of mainly corporate income tax, they are applicable, with some modifications here and there, to other taxes such as on wealth, capital gains etc. on the corporations.