

CHAPTER V

TAXATION OF CORPORATE INCOME

In the preceding chapter, one problem of corporate taxation, namely, "Why should corporations be taxed" is dealt with. In this chapter, the second problem of corporate taxation, namely, "How should corporations be taxed", will be discussed in all its aspects. In this connection, a detailed study of different approaches to corporate taxation and different problems of corporate taxation will also have to be undertaken.

But, before dealing with the approaches and problems of corporate taxation, it is worthwhile discussing some important concepts which have a bearing on corporate taxation. Since the concept of "income" is differently interpreted by different economists, a question may arise as to which interpretation of "income" is scientific or acceptable as far as principles and practice of taxing a corporation are concerned. Some important issues which boil down to the surface are: What is meant by "income"? Is there a theory of income? These and such other questions arise when one tries to find out what constitutes taxable income.

The nature of income has been the subject of much discussion and disagreement. There are three broad concepts of income: economic concept, accounting concept and income tax concept.

As regards the analysis of the economic concept of income, a brief reference may be made to some theories.

of income which try to throw light on the concept of income, from different points of view. Irving Fisher defines income in terms of services rendered. According to the "consumption or Expenditure Theory" of income stated by him, income is a flow of services through a period of time. That means commodities as such have no place in this definition. Income is received only when service is rendered-- service by property or person. The value of an income is the value of "services" of which it consists. Precisely, income is the monetary value of the flow of services enjoyed by an individual within a given period of time. This theory ignores the ability to pay. It also excludes savings from income. So, it is unrealistic and not a proper guide for taxation purpose. (1)

(2)
Therefore William W.Hewett put forth "the flow of goods and services" theory according to which net individual income is the flow of commodities and services accruing to an individual through a period of time and available for disposition after deducting the necessary cost of acquisition. This theory has "accrual" approach, while Fisher's theory has "consumption" approach. The "accrual" approach may involve double counting, since savings are counted as a part of income in the period in which they accrue.

(1) The Nature of Capital and Income, 1906 by Irving Fisher, page 52.

(2) The Definition of Income and Application to Federal Taxation, 1925 by W.W.Hewett, pages 22-23.

The third theory of income known as "the accretion of economic power"⁽³⁾ theory was put forth by Robert M. Haig who says that income is the money value of the net accretion to one's economic power between two points of time. This theory defines income in terms of "power" to satisfy human wants rather than in terms of the satisfactions themselves. This concept is of the "accrual" type. It implies that income is a flow of satisfactions and benefits. This does not go against equity. So, it is more reliable and practical. For tax purposes, this theory is more suitable.

The above discussion reveals that the economic concept of income ranges between the extremely intangible psychological factors to the very practical factors. The broadest idea is that income is the total of psychological satisfactions received. Some ignore satisfactions and include only a flow of services and commodities received. The "service concept" is more or less similar to the "satisfaction concept" and excludes savings from income. These concepts are impractical, since one cannot measure subjective items. Hence a more useful definition of income is the money value of accretions to economic power. Money value is measurable. This concept, as pointed out earlier, is agreeable with the broadest accounting concept. It is a net income concept.

(3) The Federal Income Tax, 1921, by Robert M. Haig, page 7.

The accounting concept of income has two principal notions of income. One is an operating income concept. The other is an all inclusive concept. These two are self-explanatory. There seems to be a definite trend in accounting thought towards the definition of income in terms of total rather than so called operating income. This type of basic accounting idea of income as the ultimate total profits of an enterprise is almost the same as broad economic idea of accretion to economic power.

Later on a modification of the "accrual approach" of income was introduced by Prof. Henry Simons who defined income as, "the algebraic sum of the market value of rights exercised in consumption and the change in the value of the store of property rights between the beginning and the end of the period in question"⁽⁴⁾. According to this definition, income is the sum total of two separate elements, namely, personal consumption and net capital accumulation.

This approach focusses attention on a fundamental aspect of the concept of income as reflecting the increment of "spending power" or "economic power" in a period. Income is a measure of the increase in the individual's command over resources in a period, irrespective of how much of that command or

(4) Personal Income Taxation, 1938, by Henry Simons, pages 49-50.

how little of that command he actually exercises in consumption. The personal choice of an individual as to how much he spends and how much he saves is irrelevant to this notion. Income is the sum of consumption and net savings. "Net savings" include the whole of the change in the value of a man's store of property rights between two points of time, irrespective of whether the change has been brought about by the current addition to property which is saving in the narrower sense; or whether it has been caused by accretions to the value of property.

From the point of view of an individual's command over resources, it is the change in the real value of his property which alone matters, and not the process by which that change was brought about. It is for this reason that some argue that, "in fact, no concept of income can be really equitable that stops short of the comprehensive definition which embraces all receipts which increase an individual's command over the use of society's scarce resources-- in other words, his net accretion of economic power between two points of time".⁽⁵⁾

Ofcourse, on the basis of Prof.Simon's definition of taxable income, all irregular receipts of whatever kind

(5) Kaldor's Memorandum of Dissent, Report of the Royal Commission on Taxation of Profits and Income, 1955, page 355.

fall within the scope of income, since they must all be reflected in either consumption or the net change in capital assets and so do net capital gains, whether realised or not (net after full allowance for capital losses, realised or unrealised). This concept is usually referred to as Accrued income which is seldom considered as a basis of taxation, since it is difficult to measure net change in capital values over a period.

Hence, one has to search for another concept of income, namely, realised income. This differs from accrued income in that capital gains and losses are only brought into the calculation when they are realised i.e. sold for cash or otherwise disposed of by their owners. "It is not always recognised, and should therefore be emphasised, that Realised Income can only differ from Accrued Income with respect to timing, provided that any kind of change in the ownership of assets reckons as realisation."⁽⁶⁾ This means that over a tax payer's whole life, the accumulated total of realised income should come to the same as the accumulated total of accrued income.

In general, it can be said that a tax on realised income can be postponed as compared to a tax based on accrued income, since investors may not realise ~~their~~

(6) An Expenditure Tax, 1955, N.Kaldor, page 38.

their capital gains during their life time at all. It is therefore that Mr.Kaldor suggests that the only way of going much nearer an equitable system of taxing according to one's taxable capacity is to bring about drastic changes in the existing principles and methods of taxation. This is possible if (i) the existing system of income taxation were supplemented by an annual tax in capital wealth, (ii) the concept of "taxable income" were extended to embrace all forms of wealth accrual and not merely the conventional types of income payments and (iii) the inequities consequent upon year to year fluctuations in the tax base were eliminated by the adoption of a system of "cumulative averaging" of income.

Mr.Kaldor goes further when he explains income as consumption, income as interest, income as standard stream, income ex-ante and ex-post, income as dividend, social income and individual income. Though the concepts of income advanced by Prof.Simons and Mr.Kaldor are fundamentally different from the concept of income adopted in different countries for tax purposes, it seems Mr.Kaldor has been able to come very near the "income tax concept of income" when he states that," not only is our existing definition of income for taxation purposes an extremely defective measure of taxable capacity, but any conceivable alternative definition is also bound to be defective

in varying degrees, even when taken in conjunction with supplementary taxes on capital wealth..... A more fundamental difficulty lies in the element of inherent arbitrariness or immeasurability in the very notion itself which no amount of legislative revision or refinement could hope to eliminate⁽⁷⁾!

In the light of the above approaches to the concept of income, it becomes interesting to discuss the "income tax concept of income". The income tax concept of income is a practical concept as adopted in the different countries of the world. It is sometimes known as a legal and practical concept of income. A brief discussion on the concept of income as adopted in the U.K. and India would be useful.

In the U.K., "generally speaking, no income is recognised as arising unless an actual receipt has taken place, although a receipt may take the form of a benefit having money's worth received in kind as well as of money or of a payment made to a third party in discharge of another's legal debt"⁽⁸⁾ In other words, income is said to arise when actual receipt has taken place. According to this approach, in calculating a person's income, an increase in the value of

(7) An Expenditure Tax, 1955, N.Kaldor, page 25.

(8) Report of the Royal Commission on the Taxation of Profits and Income, 1955, page 7.

property that a person may own or even a net increase in value of his/her total resources should be excluded. This means that all types of receipts should not be considered as income to constitute taxable income. Only those receipts which may conform to a class of receipts recognised as income (according to the above definition) may be said to represent a person's taxable income or taxable capacity.

The classification of receipts may assume two forms. The first form may indicate a kind of receipt of an income nature, e.g. interest, dividends, annuity etc. The second form may refer to a kind of source which is regarded as being inherently productive of income, e.g. land, trade, profession, securities, employment etc. Obviously, it is easy to determine the first form on the basis of the available facts, but it is very difficult to determine the second form; because, in the case of this type of receipts, one has to determine, first of all, whether a recipient owns one of the specified sources to which the receipt can be related; and also one has to find out whether the relation of such a receipt to that source is such that it can be said to grow out of it by way of annual increment. These difficulties are likely to create confusion due to the fact that in most of the cases, the income to be taxed is not receipts themselves but profits representing the balance between receipts and deductible expenses. Therefore, "referability to a defined source is

essential to permit of a receipt being categorised as income, unless it falls within the limited class of receipts that are identified as income by their own nature!"⁽⁹⁾

In the U.K., according to the Income Tax Act of 1803, upto 1955 the classifiable incomes were divided into five schedules. This necessitated the adaptation of increasingly complex forms of income to the general structure of the tax code. From time to time, some alterations by changing or increasing the list of sources had to be made with a view to including (or excluding) a particular type of receipt in the category of taxable income.

Some other difficulties that are likely to arise in connection with this approach to the concept of income are about some debatable items that may fall within the range of receipt that may not admit of a clear demarcation between capital and income. For instance, a payment made for the right to own an income producing asset such as free hold land. All such payments can be described as "expected future income" in the hands of the recipient and, as such, partaking of the nature of income. The other difficulty arises from the fact that from the point of view of taxation, a receipt to be identified as a receipt of taxable income

(9) Report of the Royal Commission on the Taxation of Profits and Income, 1955, page 8.

is to be judged in relation to its character in the hands of the recipient. For instance, a tax on shareholders' dividend. These types of receipts may be conveniently taxed at a flat rate. But, under a system of some tax-exemptions and personal allowances which may depend upon a person's total income and personal circumstances, some degree of inconsistency may take place in fixing the effective rates of tax on income. Under these circumstances, whether to treat a receipt as income or not will greatly depend on the status of a receipt in the hands of the recipient. Of course, in determining the status of a receipt in the hands of a recipient, it is not always necessary to inquire whether the payer charges it to his income or his capital account or sources from which he might have drawn it or whether it would be an item of a deductible expense in his own computation of taxable income.

To overcome some of the difficulties mentioned above, the Indian Taxation Enquiry Commission (1953-54) has rather modified the concept of income by emphasising the degree of regularity in getting income. The Commission states that "a commonly accepted feature of income is that it should be received with some degree of regularity." ⁽¹⁰⁾ But, this

(10) Report of the Taxation Enquiry Commission, 1953-54, Vol.II, page 3.

modification was relaxed as early as in 1918 when under the Section 3(2) (viii) of the Income Tax Act, receipts of casual or non-recurring nature which may arise from business or profession were brought under the charge of the income tax. A more significant variation of the concept of regularity was effected between 1st April 1946 and 31st March 1948 when capital gains tax was introduced in India. Ofcourse the Commission has confessed that, "though a precise definition of income is not given in the Income Tax Act, it is quite clear from the Act that the charge is to be applied only to "net" income, that is, it should not fall on capital or on any element of necessary cost"⁽¹¹⁾. Thus, the Commission agrees that from the point^{of view} of taxation, It is quite necessary to distinguish between gross income, net income, and cost element in income.

So long as there is cost of obtaining income, a receipt certainly represents a gross income. When a receipt represents a yield upon a stock, it is a case of net income or net receipt, since there is no cost of obtaining it in this case. In all cases when income involves cost, taxable income may consist of the balance of receipts from a classified source over the cost of obtaining them. Since the cost of

(11) Report of the Taxation Enquiry Commission, 1953-54, Vol.II, page 40.

obtaining income varies from source to source, the tax should not be levied upon the gross incomes from a particular source. A tax should be imposed after granting for allowances or concessions in recognition of the cost of obtaining it. Precisely, there can be no taxable income unless and until the necessary cost of obtaining incomes has been adequately and properly computed. Ofcourse, there still remains a dispute as to what is the true cost of obtaining a particular income in particular circumstances. One more disputable problem is about the expenses in acquiring a source of income or assets that belong to a source. For this, too, some allowances are to be granted.

Further, while calculating the costs deductible for the tax purpose, it should be noted that all economic costs are not ~~a~~llowed as costs deductible for tax purposes. For instance, for income tax purposes, taxable profits may be regarded as comprising three elements: (i) interest on capital (ii) a return for bearing risks and (iii) residual or pure profits. Economic costs already include the equivalent of interest on equity capital, as well as interest on contractual obligations. The tax law permits the deduction of interest payments but not imputed interest on equity capital. Similarly, insurance premiums are

allowable as costs, but returns to the owners for carrying the risks inherent in the enterprise are not deductible. Since the corporate income tax makes no distinction among the three elements and the first two are properly regarded as costs, the tax falls in part on necessary costs.

From the above discussion, it becomes clear that the concept of taxable income is not merely a creature of economic thought but is also influenced, from time to time, by judicial pronouncements and the evolution of accountancy principles. Therefore, it is rather difficult to give a standard definition that has to cover so multi-farious a subject as taxable income. On the other hand, the more particular the definition, the more it tends to become a mere list of different classes of receipts, though of course the legal decisions always talk that income tax is a tax on net income. It is for this reason that Carl Shoup states that, "the task of ascertaining the more important economic consequences of a tax of general scope such as that on corporate profits is more clearly recognised to be huge, complex and altogether of quite a different order..... Piecemeal approaches to the corporate income tax problem will have to accompany broad theoretical forays for some time to come, until it becomes much more evident where

research can be most fruitfully concentrated."⁽¹²⁾ However, a widely acceptable concept of income for tax purpose is the net realised increase of economic power from all sources, measured in terms of money, between two points of time, excluding additional investments and withdrawals of capital.

Having known the concept of taxable income, one pertinent question that may arise is: how should corporations be taxed? This simple question has been baffling the minds of thinkers and the taxing authorities too. In this connection, a number of interesting issues can be raised. What should be the guiding principles in levying a tax or taxes on corporations? Should all types of corporations--- large, small, foreign, native, financial, non-financial, old and new-- be treated equally or unequally for tax purposes? Should a corporation be regarded as an institution or entity separate from its shareholders or should it be regarded as a joint entity inseparable from shareholders for tax purposes? Should there be a progressive or proportional tax on corporations? These and such other issues will have to be tackled in order to know the technique or method of taxing the corporations.

There are two broad approaches on the tax treatment of corporations. One is the "separate entity" approach and the other is the "integration approach". These two approaches aim at tackling the issues mentioned above. Since these two

(12) "Some Problems in the Incidence of the Corporation Income Tax," by Carl Shoup, in "American Economic Review", Vol. I, May, 1960, No. 2, page 457.

approaches are already described in general in chapter I, a brief discussion of these two approaches will be enough.

According to the "separate entity" approach, a corporation has certain special features such as immortality, individuality and legal status. So it is an entity quite distinct and separate from its participants, say, members or stockholders. Hence special taxes should be devised for corporations and for their shareholders separately. The U.S.A. follows this approach for corporate tax purposes.

The second approach is based on the belief that a corporation would mean nothing but its members — their funds, their economic activities etc. Therefore, corporations should be taxed only once i.e. the members who receive income from the corporation should not be taxed again for that income. It suggests that a benefit of proportionate "grossing" of dividend should be given to the members. Originally, the U.K. treated a corporation as an association of shareholders on whose behalf the corporation had to pay the tax. In India also, upto 1959, "grossing" of dividend was granted to the shareholders, since Indian concept of corporation was based on the British version. Now, in India, a corporation is regarded as a separate taxable entity. So, both a corporation and its shareholders have to pay income tax separately and no "grossing" of dividend is allowed.

Once a country adopts one of the above-mentioned two approaches, it would face with a problem whether to impose a flat rate or progressive rate of tax on corporations. Since a corporation is an artificial person, in most of the countries of the world, a corporation is taxed at a flat rate, and not on the basis of the ability to pay. The problem of maximising economic welfare does not arise in the case of a corporation which is a fictitious individual and not a natural person.

Then the most fundamental issue that may arise in connection with corporate taxation is about the possibility of integration of the personal and corporate taxes. Of course, this issue of integrating personal income tax and corporate tax may arise, if the basic principle is accepted that as far as possible income should be taxed at the same rate, irrespective of the form of business organisation through which income is earned. If complete integration could be achieved, it would ensure certain advantages. It would eliminate all inequity due to the arbitrary elements in the tax structure unrelated to personal ability to pay which arise from separate taxation of income earned in the corporate form of organisation. It may also encourage the flow of outside equity capital to the corporations. Moreover, it may eliminate or lessen the shifting of the income taxes to the consumers.

There are three major approaches to integration of the personal and corporate taxes. The first is to treat corporations as partnerships. So, it is called "partnership approach". The second approach which is called "the dividend-received-credit approach" and which assumes three broad forms, allows stockholders the tax credit toward their personal income tax liability for corporate taxes paid. The third one known as, "the dividend-paid-credit or the undistributed profits approach" could exempt the amounts paid out as dividends from the corporate tax.

The partnership approach implies that while taxing, a corporation should be completely ignored; and all earnings of a corporation should be taxed directly to the owners. Under this scheme of taxation, all taxes on a corporation would be removed. Dividends would be treated as regular income and taxed accordingly. The undistributed profits, though not distributed or received by the stockholders, should be allocated to individual stockholders and taxed. This means the same tax treatment should be made applicable to a corporation as is applicable to a partnership. The tax burden would remain the same on all earnings of a corporation as on other income; and the tax liability would be unaffected by the dividend policy of a corporation.

This method may be more suitable for closely held or small corporations. So, it has been adopted for such corporations in the U.K. and Australia for many years. Since

the small corporations do not differ fundamentally from partnerships, their earnings can easily be allocated among the various owners and since the owners enjoy a direct voice in the dividend policies of the small corporations, they can avoid difficulties arising from taxation of income which they had not actually received. The partnership treatment would certainly be advantageous to closely held corporations which may not be expanding rapidly and whose owners thus would like to withdraw earnings as dividends.

For large corporations, this method may not be suitable. It will have to face a number of difficulties such as allocation of earnings and ploughing back of profits. The difficulty of allocation of earnings would arise when a corporation has diverse security issues outstanding. This will make the task of allocation very difficult. Further, the cumbersome procedure of allocating and notifying cannot be overlooked. In the case of inter-corporate stockholders, these problems may become more complicated. The difficulty regarding profit retention arises from the fact that the average stockholder of a large corporation has no direct influence on the dividend policy. If a corporation decides to retain substantial amounts of profits, the stockholders would be taxed on money which they might not receive and over whose disposition they could exercise no direct, real control. This is likely

to discourage persons from buying stock in big corporations.

Therefore, the partnership approach can be adopted conveniently only for small corporations and not for large corporations. If it is on optional basis, the tax payers would avail of it only when tax relief would result. Therefore it should not be entirely on optional basis. In the U.S.A. in 1958, to help small businesses, the Government authorised corporations having not more than ten stockholders to elect the partnership basis for income taxation if they wished. The privilege included the right to pass through operating losses to the stockholders.

The second approach, namely, the dividend-received-credit approach, which allows the stockholder a credit for taxes paid by the corporation on the portion of profits paid out as dividends, takes three forms. The first form suggests withholding method as adopted by the U.K. When a stockholder determines his tax liability, he includes in his income both the dividends and the tax paid by the corporation on the dividend income (which is reported to him by the corporation). After calculating his tax liability, he subtracts from his reported share of tax paid by the corporation. If his total income is such that the amounts thus "withheld" exceed his total income tax liability, he can ask for a refund. Undistributed profits are taxed at the usual corporate tax rate. Thus, as far as the dividends are concerned, the amount of income tax applicable

to corporations is to be regarded simply as a withholding levy, comparable to the withholding collections for the personal income tax on wages and salaries. The merit of this method is that it ensures equitable treatment of dividend income. Though it does not ensure the treatment of the undistributed profits at the same tax rate as would be applied in the absence of the corporate form of business organisation. But, it very effectively eliminates the inequitable treatment of the individual stockholders. The U.K. has adopted this method of tax treatment. But, the U.K. also imposes a ten percent profits tax on corporations, which is not integrated with the personal tax.

The second form of this method has been adopted by Canada which does not allow full credit; it gives a partial credit to the stockholder for corporate tax paid. The tax payer, while calculating his income tax liability, includes all dividends in taxable income. Then, he calculates the amount of tax to be paid on his income, and subtracts from the tax due an amount equal to 20 percent of the dividends received from the corporations. In the case of small corporations, the credit covers the entire tax paid by such corporations. While the credit covers only a portion of the tax paid by corporations with larger profits. In Canada, on profits in excess of \$ 20,000, the maximum rate of tax is

47 percent. The amount of tax paid by the corporation on the sum paid out as dividends is not included in the income of the stockholder.

This system does not ensure complete integration and hence does not eliminate all inequity. Especially, it does not lessen the tax burden on the very low income stockholders. Canada preferred this method mainly because it is somewhat simpler and involves less loss of revenue than the British type. What Canada has bothered for is the danger that the heavy personal and corporate taxes might check the expansion of business. Equity considerations are given secondary importance.

The U.S.A., in 1954, adopted the limited version of the Canadian system. Under this scheme, the first \$ 50 of dividend income received by each tax payer is completely exempted from tax. For the amount of dividends in excess of \$ 50, a tax credit equal to the 4 percent of the amount of dividends is allowed. In order to avoid blowing up of the credit in the higher income brackets by progressive rates, the "credit-against-tax" system was adopted instead of the "deduction-from-income" system. But, because the U.S.A. has not increased the amount of tax credit to a higher figure, the available tax credit forms only a small portion of double taxation.

The third form was adopted in the U.S.A. before 1934 when corporate dividends were exempted from the normal tax rate of the personal income tax; but, they were subject to a surtax. Such a scheme could be implemented, because for a number of years, the personal and corporate income tax rates remained almost equal. So, the condition on which the success of this scheme would depend is that for a fairly long period of time, the basic rates of personal and corporate income tax should remain similar. As in Canada, in the U.S.A. too, no relief is allowed to low income stockholders who do not have a personal tax liability.

So far, the three forms of the dividend-received-credit approach are discussed. From the discussion it becomes obvious that though the British system seems to be more satisfactory from the point of view of integrating personal and corporate income taxes, it is more complicated than the other two forms. At the same time, it should be admitted that none of these three forms can achieve complete integration. They cannot surpass the partnership approach in this respect. Further, under these schemes, a stockholder gets a completely unwarranted bonus in all these cases in which a corporation is able to shift the tax to the consumers. Such a bonus becomes free from any income taxation and hence not justified

on the ground of justice. At best, it could be defended as an incentive for business investment. Also, these schemes do not ensure equal treatment of undistributed profits and other income. Therefore, one is tempted to point out that a more reliable and satisfactory solution of integration may lie in the direction of adjusting the tax burden at the corporate level.

Hence it should be attempted to know whether or not the more satisfactory solution of the problem lies in the "dividend-paid-credit or undistributed profits" approach. This last approach allows corporations to subtract amounts paid out as dividends in determining taxable profits. That means the dividends would be fully taxed and the corporation would be taxed only for the portion of undistributed profits. Consequently, for tax purposes, the dividend income would be regarded as other income; no question of refund to the low income stockholders would arise. This also would mean that a part of the tax is shifted from the corporate level to the stockholders; so ~~removes~~ the possibility of shifting the tax to the consumers and thereby enabling the stockholders to earn an unwarranted bonus, would be eliminated. It would also eliminate all incentives for debt financing.

Having discussed all the three approaches, the question that may arise is: Which of these approaches

is more suitable ? It may be said that the partnership approach seems to be more feasible for small, closely held corporations; and for large corporations, the dividend-paid-credit or undistributed profit approach is more suitable. But, this method may cost revenue. So, necessary adjustments in the personal income tax slabs to off-set the revenue loss will have to be introduced.

In India, as will be clear from chapter VI, upto 1959 when "grossing" of dividend was in vogue, the shareholders were getting the tax credit. It was the "dividend-received-credit approach". Now, India has adopted the "dividend-paid-credit" or "undistributed profit" approach with a big modification. A corporation has to pay income tax on total profits. From these total profits when dividends are distributed to shareholders, again the income tax is to be paid on the portion of dividends by the shareholders. So, the portion of dividend which forms a part of total profits is taxed twice. And, thus, this scheme is likely to nullify some benefits of this approach. For instance, this type of double taxation may discourage equity investment. It may adversely affect the new corporations which have to retain large amounts of profits. A detailed discussion of these issues will be undertaken in chapter VI.

In general, it can be said that feasibility of a particular approach in a particular country may depend on a

number of factors. Whether a country wants to assist the growth of small corporations or not. Whether the taxing authority is guided mainly by revenue motive or equity motive. Whether the Government wants to boost up investment or check it. The predominance or otherwise of foreign stockholders is also a factor to be considered. For instance, Canada preferred the dividends-received-credit approach to the undistributed profits approach for one important consideration that a very high percentage of dividends of Canadian corporations are paid to non-Canadian stockholders. Accordingly, much of the benefits of the undistributed profits scheme would go to foreign stockholders. So, Canada with a view to confining the benefits to Canadian investors made a choice for the dividend-received-credit scheme. Historical or political factors also are to be considered. For instance, India's corporate tax system upto 1947 was mainly patterned on the British system. Therefore, one cannot sit in judgment and say this is the best or the worst method. It all depends on the economic and political conditions of a country concerned.

Ofcourse, originally there was a simple method of taxing a corporation. It was generally believed that the taxation of corporate income should be determined on the basis of the aggregate income of the individual stockholders. This was supposed to be a more convenient method of taxing such income in the hands of a corporation before distribution than

to tax its aliquot parts in the hands of the several stockholders or other corporations after the distribution had taken place. This view was also consistent with a flat rate tax. But, now the taxation of corporations is bristled with some more complicated problems which will be briefly discussed in the paragraphs to follow.

The most complex problem connected with corporate income taxation is about the determination of "taxable net income". Usually, first of all, gross income is computed and then from the gross income, the allowances for wear and tear, exemptions, deductions etc. are accounted for and thereby net income is arrived at. If a proper determination of net income is not done, economic consequences of different tax procedures (some cutting into costs or gross receipts) may follow. This difficulty becomes more baffling when the activities of a corporation are world wide and income has to be allocated equitably between various countries covered by the corporation.

The other equally complex problem is about the inter-corporate dividends. Some corporations, over and above the income they derive from their usual business, get additional incomes by holding shares in other corporations. If such incomes which they get in the form of dividends are taxed, it may result into double taxation. In the same way, evils of multiple taxation may arise in all

cases of several large layers of corporations paying dividends to one another. Hence, special provisions have to be worked out to avoid the evils of double or multiple taxation.

Accepting that the intercorporate dividends should be taxed, some provisions should be made to minimise the evils of double taxation. To solve this problem, generally two methods are practised by the different countries of the world. According to the first method, the taxing authority should plan to credit the receiving corporation with the tax withheld by the distributing corporation. The second method is to credit the receiving corporation with that part of its own income tax that corresponds to the portion of its profits made up of dividends. In Canada, a provision is made that corporations should not be taxed on dividends received from other corporations which have paid to the Government income tax on the corresponding profits. Other advanced countries like the U.K., the U.S.A., France and Newzealand have also made special provisions of the above type to avoid double taxation.

Ofcourse, one defect is inherent in both these methods. Corporations whose profits are entirely or almost entirely derived from dividends may, under either of these two methods, enjoy a very large tax advantage. To overcome this defect, the taxing authority should provide that the tax

withheld by the corporation distributing the dividend should not be credited against the corporate income tax of insurance or investment corporations, as is practised by France. However, this provision should not be strictly enforced in those countries which possess a large number of investment companies and shareholding companies and thus serve as international financial centres. Such a relaxation is necessary to bring about a diversification of investments and thereby to spread the risk over a wide area of investments.

The problem of "unreasonable" accumulations of surplus reserves has drawn particular attention of taxing authorities. In a tax system which includes a steeply progressive personal income tax, the corporate form of business organisation can be used in some cases as an instrument of tax avoidance. When there are a number of shareholders in the middle and upper brackets, a substantial tax saving may result — at least temporarily — from the withholding of earnings. These earnings may be paid out later as dividends when tax rates are lower or these earnings may be retained in the business indefinitely. In the latter event, these earnings would not be reached under the personal income tax until the shares were transferred and then only to the extent that they were reflected in the

sales price. Ofcourse, the alternative capital gains rate would be applicable to the gains of the rich shareholders.

Because of the possibility of tax avoidance, the income tax laws long included a provision penalising "unreasonable" accumulations of surplus. A penalty tax has to be charged to corporations formed for the purpose of preventing the imposition of surtax on the shareholders.

The fact that earnings are allowed to accumulate beyond the reasonable needs of the business is regarded as indicating an intention to avoid surtaxes on the shareholders, unless a corporation by the clear preponderance of evidence proves the contrary.

There are also the problems of taxation of foreign companies, depreciation allowances and tax incentives. In all these matters, there is no common practice in the world. It will be seen from the discussion in the chapters to follow that the methods of solving the corporate tax problems are different in different countries, though ofcourse, they may have in common some broad features.

One obvious conclusion that can be drawn from the above discussion is that the question of "how should corporations be taxed" is a taxing one. It is only on the basis of trial and error that a country may be able to evolve a suitable corporate tax system in the long period of time.