

CHAPTER VI

CORPORATE PROFIT TAXATION IN INDIA

Mr. Kaldor in his report on "Indian Tax Reform"

observed that, "the company taxation provisions of India (perhaps even more than that of other countries) are apt to strike a detached observer as a perfect maze of unnecessary complications, the accretion of years of futile endeavour to reconcile fundamentally contradictory objectives".⁽¹⁾ This remark invites a close study of the system of corporate taxation in India. For a proper understanding of India's corporate taxation, it would be necessary to classify the corporate taxes into two broad groups. The first group comprises of taxes levied at the corporation level i.e. taxes on corporate profits or income, capital gains, wealth, bonus shares etc. The second group may include taxes in relation to the shareholders and the shareholding companies. In this chapter, only the corporate profit taxation will be discussed.

The growth of corporate profit taxation has to be studied not merely in terms of increase or decrease in its yield, but also in terms of its more important aspects such as the principles underlying the evolution and growth of the tax system, changes in the rates structure and the different types of factors influencing the growth of the tax system.

(1) Indian Tax Reform, 1956, by Nicholas Kaldor, page 85.

in the country. Since these aspects are closely inter-related, they will be discussed in relation to one another so that an "integrated approach" to the study of the features of the growth of corporate profit taxation could be arrived at. For the study of the remaining corporate taxes, the same approach will be resorted to.

While discussing chronologically the growth of corporate profit taxation in India, the year of Independence (ofcourse in general) is taken as a dividing line for the simple reason that in the pre-Independence period, the emphasis was on revenue motive. Taxation was not thought of in relation to the economic development of the country. Only after 1947, India's entire tax system, more so her corporate tax system, has been increasingly recognised as an important tool of economic development of the country.

As regards the growth of the corporate profit taxation during the pre-Independence period, it should be remembered that it was in 1850 that the corporate form of business organisation was given legal status and after seven years, in 1857, the principle of limited liability was introduced. In order to overcome the financial difficulties which arose as a result of the political events in 1857, income tax in its modern form was introduced in the country. Between 1860 and 1886, a number of experiments were

undertaken, alternating between income tax proper and a licence tax on trades and professions. It was in 1886 that a final form of the income tax was settled and the first systematic legislation on income tax was enacted in the same year. It was also laid down to tax the net profits of a company at a flat rate.

The system of charging the net profits of a company at a flat rate remained unaltered till 1916 when an element of graduation was introduced by exempting from tax companies with an income of less than Rs.1,000.

In 1917, on incomes of companies exceeding Rs.50,000, super tax was levied. The amount of dividend paid or declared for payment was allowed to be deducted before super tax was charged. However, the dividends were made liable to super tax when they went in the hands of the shareholders. The provision of super tax was criticised on the ground that it harshly affected those companies which followed a sound policy of devoting a sizeable amount of such undivided profits to create a reserve fund. Therefore a provision was made to allow a deduction from taxable income of ten percent of the income chargeable under the Income Tax Act.

In 1918, under the Income tax, a provision was added to include dividends received by a shareholder in his total income for the purposes of determining the rate of tax on his other income, though ofcourse, the dividends continued

to be exempt from tax in the shareholders' hands.

This provision was modified under the super tax Act of 1920. According to the modified provision, companies were charged to super tax on both the distributed and the undistributed profits at a flat rate of one anna in the rupee on that part of their income which was in excess of Rs.50,000. Dividends were charged to super tax in the hands of the shareholders.

Between 1922 and 1947-48, the rates of income tax, surcharge and super tax on companies were steadily raised. This becomes obvious from the following table:-

Rates of income tax, surcharge and super tax
during 1922 - 1948

Assessment year	Income Tax	Surcharge	Super tax
1922-23 to 1929-30	18 pies in the rupee	-	Nil-for first Rs.50,000 and 12 pies in the rupee for every rupee of the remainder
1930-31	19 pies	-	
1931-32 to 1935-36	26 pies	-	
1936-37 to 1938-39	26 pies	1/12th	
1939-40	30 pies	-	1 anna
1940-41	30 pies	1/12th	1 anna
1941-42	30 pies	1/3rd	1 anna
1942-43	30 pies	1½ as.	1½ as.
1943-44	30 pies	1 anna & 8 pies	2 as.
1944-45	30 pies	24 pies	3 as.
1945-46	30 pies	27 pies	3 as.
1946-47	5 annas	-	1 anna
1947-48	5 annas	-	2 as.

Based on Source: Income Tax Manual, Part I, 1957, by
C.B.R., pages LXIV to CXLVII.

From the table, it becomes clear that rates of income tax were more or less steady between 1922-23 and 1930-31. After 1931-32, the income tax rates were steadily raised for revenue motive. Super tax rates remained steady during the period, 1922-1940. They were substantially raised during and after the Second War period. A surcharge at the rate of 1/12th i.e. 8.3 percent was levied in 1936-37. This tax was levied for some years, abolished for some other years, again reintroduced in 1951-52 and again abolished in 1959-60.

After having briefly surveyed the history of the changes in the rate structure of corporate profit tax, it would be worthwhile reverting to the discussion on the features of the growth of the corporate profit tax in the country. In the preceding discussion, features of this tax as it existed upto 1920 are described.

In 1922, a revolutionary principle was introduced in the field of corporate taxation of the country. That was the principle of "grossing up" the dividend. This principle seems to have been borrowed from the British system of company taxation. The Income tax Act of 1922 effected consolidation of the law relating to both income tax and super tax and allowed the tax credit to the shareholders for the income tax (but not for the super tax) paid by a company. The introduction of the principle of "grossing up" dividend is noteworthy for the fact that for the first time a definite view on the concept of

corporation was given expression by the taxing authority.

The procedure of grossing up dividend assumes that the assets of a company are the property of the shareholders; so care should be taken to see that after the income of a company is taxed, the dividends accruing to the shareholders out of the same income should not be taxed again. When a company declares dividends out of its "taxed profits", each shareholder is deemed to have himself paid on the dividend a proportionate amount of income tax, through the agency of company which is regarded as an entity inseparable from its shareholders. So, at the time of the assessment of a shareholder's personal income, he should be given tax credit for the amount of tax attributable to the dividend received by him. This method of taxation can be described as "dividend-received-credit" approach which is explained earlier in chapter V. According to this approach, dividends are included in the shareholders' total income at a grossed figure which includes the proportionate income tax paid on it by the company and the shareholders are entitled to a refund on the gross dividend calculated at the difference between the company rate of tax and the personal rate of income tax applicable to them on their total income including the "grossed up" dividends received by them during the year.

Upto 1938, the company tax system maintained the broad pattern evolved in 1922. In 1939, the tax system was

modified. It was decided to withdraw the exemption limit of Rs.50,000. Companies were required to pay super tax on every rupee of their income in the same way as for income tax. For the assessment year 1939-40, the rates of income tax and super tax were $2\frac{1}{2}$ annas and one anna in the rupee respectively. The amended Income tax Act of 1939 also modified the method of taxing dividends in the assessment of shareholders. It was laid down that the gross dividends should be taxed in the hands of the shareholder at the rate applicable to his personal income. At the same time, a shareholder was allowed a tax credit in his assessment equal to the proportionate income tax paid by the company on such dividends.

It has been already pointed out that one of the reasons for a steady rise in the rates of taxes on companies was that the Government wanted more and more revenue during the Second War period. But in 1945 when the War came to an end, it was realised that in order to enable the company sector of the economy to undertake the post-war rehabilitation programme, it was necessary to enable the companies to build up substantial reserves. For this purpose, under the Finance Acts of 1944 and 1945, a provision was made to grant a rebate of super tax of one anna in the rupee on the total income of a company as diminished by dividends declared on equity shares. This provision was in the nature of a tax relief.

In 1946, a differentiation between distributed and undistributed profits of a company was introduced for tax

purposes. This was felt as a necessary measure to prevent the companies from distributing excessive amounts of dividends. It was laid down that an additional super tax should be levied on all companies which distributed dividends amounting to more than 5 percent of the capital and 30 percent of the total income of a company. The additional super tax rates were fixed at graded rates rising from two to seven annas in the rupee. This system continued upto 1947.

It would be useful now to sum up the important features of company taxation of the pre-Independence period:-
First, the basic framework of company taxation evolved long back when the economic development of the country was not the main goal of the British Government. The emphasis then was on revenue.

Second, as far as companies were concerned, there was no tax exemption limit. The practice was to equate the rate of income tax applicable to a company to the maximum rate of income tax as distinct from super tax prescribed for any financial year.

Third, the shareholder was entitled to the refund of income tax paid by the company on the dividend received by him. For this purpose, the dividend was "grossed up" and added to the shareholder's income to determine his personal tax liability and the amount of tax credit to which he was entitled.

Fourth, no specific tax relief was made available to new and

small companies.

After Independence, a number of changes have been introduced in the field of company taxation. Before discussing these changes, it would be useful to study the rate structure of company profit taxation since 1948. The following table gives a summary of the rates of income tax, surcharge and super tax for the period, 1948-1962.

RATES OF INCOME TAX, SURCHARGE AND SUPER TAX DURING 1948-61

Assessment year	Income tax	Surcharge	Super tax
1948-49	5 as.	-	-
1949-50	5 as.	-	-
1950-51	4 as.	-	-
1951-52	4 as.	1/20th	-
1952-53	4 as.	"	-
1953-54	4 as.	"	-
1954-55	4 as.	"	4 as. & 9 pies
1955-56	4 as.	"	4 as. & 9 pies
1956-57	4 as.	"	6 as. & 9 pies
1957-58	30%	"	5 as. & 20%
1958-59	30%	"	20%
1959-60	20%	-	25%
1960-61	20%	-	25%
1961-62	20%	-	25%
1962-63	25%	-	25%

Based on Sources: (1) Income Tax Manual, part I, 1957, by C.B.R. pages LXIV to CXLVII

(2) Budgets for 1958, 1959, 1960, and 1961, 1962

The table reveals that the rates of income tax and super tax have not shown any consistent rise or fall; the surcharge was abolished in 1959-60.

As regards the changes in company taxation during the post-Independence period, it may be mentioned that in 1948 the first important change in the company profit tax system was that the method, which operated in the form of a penalty for excessive dividends, was replaced by a rebate of income tax at the rate of one anna in the rupee on the amount by which the disposable income of a company (i.e. its total income as reduced by seven annas in the rupee) exceeded the dividends declared. When profits which were retained in one year and had attracted rebate were distributed in the subsequent year, additional tax had to be paid on such distribution at a rate equal to the difference between five annas and the amount of tax actually paid on these profits in the year when they were earned and retained.

Again in 1948, with a view to helping relatively smaller companies, a principle of differentiation was introduced. According to this principle, the taxing authority collected income tax at $2\frac{1}{2}$ annas in the rupee on companies whose total income did not exceed Rs.25,000. Whereas, the companies whose total income exceeded Rs.25,000 had to pay 5

annas in the rupee. Since 1949, this differentiation has taken the shape of an additional rebate of one anna in super tax to companies whose total income would not exceed Rs.25,000.

Also, in 1948, a distinction between Indian companies and non-Indian companies was introduced. Only an Indian company became entitled to a rebate of income tax at the rate of one anna in the rupee on so much of its profits as were available for distribution in respect of any previous year but were not actually distributed as dividends. Also, an Indian public company whose total income did not exceed Rs.25,000 was made to pay income tax at the rate of $2\frac{1}{2}$ annas in the rupee only as against other companies whose total income exceeded Rs.25,000 which had to pay income tax at the rate of 5 annas in the rupee plus surcharge.

In substance, this scheme of granting rebates to Indian companies was designed to encourage the companies to plough back their profits into business rather than allow them to reach the shareholders. This scheme remained in force till the assessment year 1955-56.

In 1949-50, the income tax rate remained unaltered.

- In 1950-51, it was lowered from 5 annas to 4 annas in the rupee.
- In 1951-52, though the rate of income tax remained unaltered, a surcharge at the rate of 5 percent was levied. During the period, 1952-56, these rates were not altered.

The rate of super tax was raised from 3 annas in 1948-49 to 4 annas in 1949-50. It was raised to $4\frac{1}{2}$ annas in 1950-51 and $4\frac{3}{4}$ annas in 1951-52. During the period, 1952-1956, the rate of $4\frac{3}{4}$ annas remained unaltered. It was further raised to $6\frac{3}{4}$ annas in 1956-57.

In 1956, a number of far reaching changes were introduced in the field of company taxation. The Finance Act of 1956 reintroduced capital gains tax. A detailed discussion of this tax will be undertaken at a later stage. This Act also brought into force a new tax called the excess dividends tax. This tax was designed to encourage the companies to plough back their profits, since any company, Indian or non-Indian, was asked to pay this tax if the company distributed dividends during the previous year in excess of the prescribed percentage of the paid-up capital. This Act made a provision according to which the maximum tax that could be levied on excess dividends for 1956-57 was not to exceed 25 percent of the total income. The corresponding figure fixed for the year 1957-58 was 37.5 percent of the total income.

When the excess dividends tax was announced, it raised a storm of criticism. It was pointed out that on one hand the statute required a private company to distribute more dividends in order to save from penal super tax payable

under section 23-A. On the other hand, another statute required the company to distribute less dividend, if it wanted to escape the excess dividend tax. This tax also penalised the more efficient and hence more prosperous and successful companies which earned a high rate of dividend. This tax proved to be a premium on inefficiency, since inefficient companies would not have to pay this tax. Hence this tax was abolished in 1959 under the new scheme of company taxation.

In order to prevent the companies from evading the excess dividends tax a new tax, namely, a tax on bonus shares was levied in 1956. A detailed discussion of this tax will be undertaken in a separate chapter.

Under the Finance Act of 1957, the rate of income tax for all the companies was raised from 25 percent to 30 percent and the rate of surcharge of income tax was continued at 1.5 percent. The basic rate at which super tax was payable on the whole of the total income was fixed at 50 percent; but rebates were allowed at varying rates from the basic rate to different classes of companies satisfying certain conditions. The effective rate on a public company with income above Rs.25,000 was 51.5 percent. In substance, however, the scheme of company profit taxation remained virtually the same as under the Finance Act of 1956.

The Finance Act of 1957 introduced a new tax, namely, wealth tax on companies at a rate of $\frac{1}{2}$ percent. A detailed discussion of this tax will be undertaken at a later stage. Also, the Finance Act of 1957 proposed an amendment in section 23-A. The amendment did not suggest any major change in the basic scheme of the section. This amendment will be discussed at length in chapter VIII.

For the year 1958-59, the scheme of company taxation remained almost ~~undisturbed~~. Whereas, in the Budget proposals for 1959-60, a number of sweeping changes were made in the company tax system of India. Therefore, it is known as a new scheme as against the old scheme of company taxation which was in force upto the assessment year 1958-59.

In 1959, the Budget proposals reflected the need for simplification of the tax system of the country. It also emphasized the need for boosting up the investment psychology. Hence, while announcing the Finance Act of 1959, some big changes were proposed. The proposals of the Finance Act of 1959 are a landmark in the history of company taxation of India. The main proposals were as follows:-

- (1) As from 1960-61, the wealth tax on companies and the excess dividends tax were abolished. The net incidence of the taxes on income, wealth and excess dividends was to be concentrated in the income tax and super tax rates of companies

which together came to 45 percent.

(2) The system of "grossing up" the dividends was abolished.

Under the new arrangement, the companies paid a non-refundable tax on their profits at the rate of 45 percent and in addition they were required to deduct tax at the flat rate of 30 percent from the dividends to the shareholders and credit it to the Government. This tax could be reimbursed to the shareholders at the time of their assessment, as has been the case for interest on Government securities.

Thus the Finance Act of 1959 introduced a novel feature in the system of company taxation in India. Upto 1958-59, companies were not asked to deduct any income tax at source on payment of dividends to resident shareholders since the shareholders themselves were deemed to have paid the income tax through the companies. So, there arose no question of deducting income tax on dividends. Ofcourse, there did exist a provision for the deduction of income tax and super tax from dividends paid to the non-resident shareholders. Now under the new scheme, companies have to deduct income tax at prescribed rates on all dividends distributed by them. No part of the income tax paid by a company is to be regarded as having been paid by the shareholders who are not allowed any credit in their personal assessments.

The Finance Act of 1959 had proposed a rate of 30 percent for deduction at source by a company on dividends paid to resident shareholders, and a rate of 45 percent on dividends paid to Indian companies. Experience showed that these differential rates caused confusion and so a uniform rate for deduction of tax on dividend paid to any assessee, individual or company, at 30 percent was proposed by the Finance Act of 1960. As a result of this change, an amendment was added to this Act so as to enable the Government to collect from Indian companies the remaining 15 percent as advance tax on the dividends received by them.

The Finance Act of 1960 also provides that the deduction of tax at source from dividends on preference shares should be at the same rate as deduction of tax at source from dividends on ordinary shares. The Act of 1959 prescribed that in the case of the payment of preference share dividends which are of a fixed rate and free of tax, the tax to be computed at source should be calculated on such amount as after deduction of a sum equal to 30 percent thereof be equal to the net amount of preference dividend received by the shareholders. The Government thought that the companies would adjust their preference dividend declaration in such a way as to entitle the same amount of tax before. But, a number of companies did not do so. The shareholders, who suffered, raised a hue and cry. Therefore, under the 1960

Act, it was laid down that companies would be free to decide as to what amount they should declare as dividends to the preference shareholders. So, now, from the amount of preference dividends declared by companies, whatever it be, deduction at source is to be made at the rate of 30 percent as in the case of any other dividend.

One important provision made under the companies' Amendment Act of 1960 was that every company had to compulsorily provide for depreciation for the year concerned as well as arrears of depreciation before declaring dividends to shareholders. The idea behind this was to strengthen the internal resources of the companies.

The questions that could be raised with respect to the new scheme of company taxation relate to the impact of the changes on tax ~~tax~~ yield, companies and the shareholders.

As regards the impact of the new scheme of taxation on tax yield, apparently one feels that there has been a reduction in taxation. But, in fact that is not the case. Formerly, the income tax on corporate profits including surcharge was 31.5 percent and the corporation tax was 20 percent. This gives a total tax of 51.5 percent on total profits. The new rates proposed are 25 percent income tax and 20 percent super tax making a total of 45 percent. Formerly,

31.5 percent income tax was treated as having been paid by the company on behalf of its shareholders. So, this tax payment was credited to the shareholder both by way of an increase in his income and by way of payment of tax. This will no longer be allowed with respect to any part of the 45 percent taxation enforced under the new scheme. Only the dividend paid to the individual shareholder will be treated as his income. At the same time, a provision has been made for the advance deduction of income tax by the company on the dividend at a standard rate. This deduction is additional to the income tax and super tax payable on the company's total income. The shareholder's income will be treated as consisting of the dividend plus the advance tax payment at the standard rate, and the advance tax payment will be credited to the shareholder as a set-off against his total tax liability. Thus, according to a rough estimate, on the distributed portion of the company profits, the tax paid by a company under the new scheme is as high as 75 percent. But, the Government's express intention in introducing the reform was only to simplify the system of taxation by abolishing the cumbersome system of grossing up. The Government's intention was not to raise additional revenue.

The revenue from corporate taxes at the rate of 51.5 percent plus 5 percent for the excess dividends tax and

the wealth tax on companies minus the quantum of income tax claimed as credit or refund by the shareholders was estimated to be equal to 45 percent of corporate profits. Since any increase in revenue from company taxes was not the Government's intention, the new rate was fixed at 45 percent. The two taxes on corporate wealth and excess dividends were also abolished along with the system of grossing up. If the company tax and shareholders' tax are taken together, no loss to the exchequer is likely to occur. Therefore, the total revenue of the Government from corporate taxation will not diminish under the new scheme.

The problem of the effects of the new scheme on shareholders has become a controversial one. The validity of the abolition of the system of grossing up dividend is also doubted. This system was beneficial to the shareholders. But the process of grossing up the dividend income was a highly complicated one. The gross dividend had to be worked out in accordance with a complicated formulaⁱⁿ which many factors such as taxable or non-taxable profits, year of declaration of dividends, the rate of income tax suffered by a company etc. were involved.

Apart from the grossing system being clumsy, it kept down the revenue from personal taxation. Since the

tax credit used to be given at the company rate of income tax which was higher than the personal rates of income tax applicable to the shareholder, the tax credit almost always exceeded the income tax payable on the dividend by the shareholder. The excess tax which was thus deemed to have been paid used to be set off against his other liabilities or refunded to him later.

One anomaly caused by the system of grossing up was about the declaration of dividends out of reserves. Here, the legal position was quite ambiguous. Whether the relevant rate for grossing up was the rate applicable to all companies in the year in which declaration of dividend was made or whether it was a rate applicable to that particular company was never clearly known. Sometimes, it so happened that a particular company paid no tax in that particular year and yet the shareholders demanded the "grossing up". Moreover, it so happened that dividends were declared out of earlier profits that had suffered a certain rate of tax, but in the year in which it was declared, the company did not have any taxable income and the income tax officers refused to give any credit for the tax paid since the relevant rate was that of the year of declaration.

With a view to overcoming the above mentioned difficulties, the system of grossing up the dividend was

abolished in 1959. Against the abolition of this system, the Taxation Enquiry Commission stated that if the grossing system is stopped, "it would not only adversely affect the interests of a large number of persons, including many in the low income groups, but may also act as a disincentive to the holding or purchasing of equity investment in general!"⁽²⁾

Therefore the commission recommended that the anomalies of grossing up the dividends should be eliminated by modifying the system. According to the commission's suggestion, the companies should first deposit with the Government the required amount of income tax on the dividends which they declare. It implies that the shareholders should be given credit on their assessment at uniform rates without any difficulty. In the assessment of companies, necessary credit should be given for the income tax which they have already paid.

But, the Government has altogether abolished the grossing up system. This has certainly simplified the company tax system. However, this raises one important question whether or not simplification has been achieved at the cost of shareholders.

(2) Report of the Taxation Enquiry Commission, 1953-54, Vol.II, page 154.

In the past, a company was charged to income tax at 31.5 percent. But, this was refundable to shareholders. The dividend received by a shareholder was supposed to have paid income tax in advance and the necessary tax credit was given to him in the calculation of his personal tax liability. Thus, if a shareholder received a dividend of Rs.100, the Government gave him a tax credit of Rs.45.99. Under the new system, the Government does not refund to the shareholders any portion of the tax received from companies. Whatever dividends the shareholders receive will be taxable as such in their hands. The shareholders will therefore suffer a loss of 45.99 percent of their dividends.

Ofcourse, the official circles argue that since the rate of income tax on companies has been reduced under the new system, they will save some amount of income tax. From these savings, companies should be able to distribute more dividends.

Ofcourse, under the new scheme too, in respect of the tax free dividends, a company will have to gross up the dividend to an amount, which, after deduction of tax at a rate of 30 percent, would give the net amount of tax free dividend. For instance, in respect of preference shares which are 6 percent tax free, a company will have to pay dividends at 8.57 percent so that after deducting therefrom tax at 30

percent which comes to 2.57, the net amount paid to the shareholder would be 6 percent. This provision is likely to increase the liability of a company in respect of dividends on preference shares. Now, a company will have to pay a **gross** dividend of 8.57 percent to the shareholders, in lieu of 6 percent tax free preference dividends under the old scheme. This will be an advantage to the preference shareholders and a corresponding disadvantage to a company.

As stated above, the revenue of the Government from company taxation will not increase as a consequence of the change. But, this does not imply that the particular companies will be unaffected. As already pointed out, the rate of grossing up dividends under the old scheme depended on a number of factors whose total influence is bound to vary from company to company and even for the same company from year to year. Though the new rates of taxation are uniformly applicable to all the companies and all of them will also have to pay the same standard rate of advance tax on dividends, the net effect is bound to vary. No doubt, all companies may not be adversely affected.

Further, the new scheme has undoubtedly introduced the element of double taxation on that portion of the income on which a company pays income tax and later on when it goes in the ~~md~~ hands of the shareholders, again it is made liable to

income tax. Also where dividend distribution is made from the reserves which had suffered income tax at a higher rate in the past, the shareholders will not be able to directly recover any tax then paid by the company on its profits and then taken to reserve. Ofcourse, it is laid down that the company shall be allowed in the current year a nominal relief in income tax, being equal to 10 percent of the dividend declared by it in respect of past taxed profits, which indirectly may result in some gain to the shareholders. But this relief, when compared with the tax treatment which such dividends met in the hands of shareholders under the old scheme, seems to be insignificant.

The above discussion brings out fully the general features of the corporate profit taxation in India upto 1961. In 1962, the Finance Minister has raised the rate of income tax from 20 percent to 25 percent. The super tax-rate has remained almost the same i.e. 25 percent but subject to adjustments. Therefore, a company will have to pay 50 percent tax on income. This is likely to hamper upon the internal finances of the companies. If they continue to distribute the amounts of dividends that they paid upto 1961, they will have to face a cut in their profits for retention. If they start lowering the dividend rates, they may not be able to attract more equity capital. This may go against the desirable goal of broadening the equity base of the corporate sector, as

emphasized by the Finance Minister in his Budget speech for 1962.

Then remains to be studied the taxation of inter-corporate dividends. This is directly connected with the problems of corporate profit taxation. So, it should be now discussed in brief.

TAXATION OF INTER-CORPORATE DIVIDENDS

One of the complex problems connected with corporate taxation is that of dividends earned by one company (which is usually known as a "shareholding" company) from another company. The dividends received by companies, barring some exceptions, are taxed in the same way as dividends received by persons. Upto 1958-59 when the system of "grossing" up the dividend was in vogue, the grossed dividend income was included in the total income of the recipient company and credit was given for income tax deemed to have been paid by it. The grossed dividend, therefore, attracted liability only for super tax in the assessment of the recipient company.

But in 1959, the system of grossing up the dividend was abolished. So, at present, on the inter-corporate dividends, both income and super taxes are levied. Dividends received by a company from a subsidiary Indian company or any other Indian company are taxed in the hands of the receiving company at the basic rate of income tax and super tax applicable to "total income" of the company.

Against the taxation of inter-corporate dividends, it has been argued that it would involve an element of double taxation. It has also been pointed out that the inter-corporate investments are made either for the promotion of subsidiaries or by institutional investors having surplus funds. This is helpful in stepping up the rate of capital formation and therefore there is a case for exemption of inter-corporate dividends from taxation.

Though, the inter-corporate investments serve a very important purpose of promoting capital formation and expansion of business, there is no valid reason why such investments should be given a differential treatment for the purpose of taxation. The Taxation Enquiry Commission, in this connection, states that, "a study made by us of the finances of private limited companies, shows that most of the companies are controlled by four or less than four persons and that investments in other companies form a high percentage of their total investments"⁽³⁾ This shows a possibility that the benefit of tax exemption will accrue in many cases in the last analysis to the persons controlling the parent

(3) Report of the Taxation Enquiry Commission, 1953-54, Vol.II, page 167.

company. Therefore, there is a strong case for taxing the inter-corporate dividends without any differential treatment. At the most, it may be suggested that if it is necessary to attract new capital in certain desirable channels, the Government may quite legitimately grant some exemptions or concessions under special conditions. Various possible methods to achieve the goal of minimising the evils of double taxation etc. are already described in chapter V.

At present, there are certain companies which are given tax exemption in respect of their inter-corporate dividend incomes. These companies are: investment trust companies and companies specified under section 56-A.

Therefore, there is enough justification for taxing the inter-corporate dividends in India without any differential treatment. In a number of Western countries, there is a tax on the inter-corporate dividends. The only loophole in the existing system of the inter-corporate dividend taxation is that there is not one uniform rate of tax. There is a number of rates of this tax, depending upon the type of company, income and the available tax deductions and exemptions.

Thus, the discussion on taxation of inter-corporate dividends completes the study of corporate profit taxation in India. From the study of corporate profit taxation, it is

possible to arrive at one obvious conclusion that India's company tax system which was based originally on revenue motive has been slowly and steadily evolved for the purpose of simplification and rationalisation. A number of complications have been eliminated. At the same time, the tax incidence is not increased in an unfair way. This will become quite clear when a discussion on the various deductions and concessions available for companies will be undertaken in the next chapter. At present, a company has to pay five taxes, namely, income tax, super tax, capital gains tax, bonus tax and penal super tax under section 23-A. This broadly explains the corporate tax structure in India.