CHAPTER II

DETERMINATION OF EARNINGS
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INTRODUCTION:
As a matter of fact, the problem of measuring the earnings from a business enterprise can be determined only at the end of its life and it is one of the most important function of Financial Accounting. It is possible to determine the net earnings only when the business is finally closed down. In order to have an idea, the earnings is determined after the expiry of a reasonable period. Such a period is termed as accounting period. It requires complete and accurate picture and clear understanding only when the business is finally closed down. Earnings are produced by the business enterprises which start with the investment of cash into productive assets known as cost and end with the conversion of assets in cash known as revenue. The difference between revenue and cost for a given period is called the profit or loss.

COMPUTATION OF EARNINGS:
The American Accounting Association states that the revenue has to be compared with the cost [or expense] for the purpose of determination of business earnings. It is necessary to analyse and study the factors which have a direct bearing on the determination of profit. Revenue are measured by the charges made to the customers for goods and services furnished to them. On the other hand costs that have been consumed, in the process
of producing revenue are expenses. Thus, revenue is determined firstly and then expenses incurred for earning the revenue are matched with the revenue for calculating the difference which is known as net profit or net loss. The basic of measuring the revenue will be correct when revenue is equivalent to cash received, expense is equivalent to cash paid out. If cash is received within the accounting period, it is reported as revenue of the period. If cash has not been received as at the end of the accounting period, no revenue is reported. The difference between the cash received and cash paid is termed as net earnings.

VALUATION OF ASSETS : This problem is concerned with the fact that the determination of earnings involves valuation. Ultimately, the value placed on the net assets, at the beginning and the end of the accounting period, determines the earnings of that period. In advanced countries the value of the net assets is computed on the basis of the present worth of the capital invested and earnings are ascertained by matching the present value of the net assets at the two accounting periods.

In India, earnings are computed by matching revenue and cost, but are brought into account as their actual monetary values. This system of accounting is known as historical cost basis. An important feature of the same is that it reduces to the minimum the possibility of accounts being affected by the personal opinion of those responsible for their preparation. It reflects the combination of recorded facts, accounting conventions and
legal requirements. The soundness of judgement depends on adherence to generally accepted principles and regularly followed methods. Thus the revenue and the cost are the two main determinants of the earnings. Both are very wide and vague. It is difficult to calculate correctly the revenue and cost for ascertaining period profits.

Traditionally, earnings were taken to be result of marketing functions like distribution and price strategies and little attention was paid to cost reduction. Increase in competition and price regulation created cost consciousness. In the present day economy, enterprises find it difficult to control trends prevailing in the market. They have to adapt their behaviour and internal working of the business for exploiting the available opportunities to the best possible advantage. Thus the management of earnings from within the enterprise involves the crucial problem of cost control and is the most effective measure of maximising profits. Cost drains away financial resources of the firm and generates at times multiple effects. Consciousness is widely acclaimed as an essential element of efficient management. The primary function of cost control is to seek the most effective ways of making and marketing goods, "The business management faces the challenge of proving that profit is good and more profit is better by revenue determination to reduce the controllable cost."*

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* Stevenson and Nelson, Page No. 13.
Though the ultimate burden of increase in cost is borne by consumers through rising prices, yet in the process of backward shifting some portion of cost lies on factors of production. Workers would have to accept lower wages or face unemployment for want of adequate profits. Government would lose tax revenue, because of lower turnover and profits. Shareholders would get lower return on their investments resulting from lower profits. It should be remembered that out of these factors, Government has become a powerful factor influencing cost and price, through taxes and fiscal policies. It can help to reduce costs by providing subsidies, bounties, tax relief and other facilities and can increase the same by levying additional taxes and accepting employees demand for wage rise. Government can also exercise direct control over the earnings by price regulations and profit-freeze, thereby curbing the management's ability to shift the incidence of cost.

It is thus evident that the concept of earning is a complex phenomenon. It is very difficult to locate and measure the effects of individual factors on determination and management of earnings. Attempts are made to highlight the impact of sources and the important factors like cost, value, volume profit relationship, financial leverage, managerial and accounting practices used, income smoothening, depreciation and tax policy on the corporate earnings.

COST VOLUME PROFIT RELATIONSHIP:
Cost volume profit relationship helps the management of companies in finding out the relationship between cost and revenue to
output. It helps in understanding the behaviour of earnings in relation to output. Such an understanding is significant in planning the financial structure of a company. It enables the business enterprises to study the general effect of the level of output upon income and expenses and, therefore upon earnings. Earnings cannot be computed by the degree of business efficiency unless it should be in relation to other factors like sales, costs and capital employed. The margin of earnings on sale does not remain constant but it varies with the volume of sales. Any small change in sales brings about a big change in earnings. Earnings are affected by the intensive use of capital and the rapidity of turnover. To ascertain the maximum earnings, management has to make the optimum use of factors of production. To make the profit volume relationship improved, there are various ways which can be adopted such as reduction in the cost of production, increase in price, increase in sales, changes in the composition of products and sales. To determine profit, it should be denominated by a factor. Sales or volume is a good factor of assessment to find profits. It is true that the projected profits must rest upon the estimation of sales, but it is difficult to forecast the volume of business due to a large number of variables such as competition from the past and future rival producers, the consumers' attitude, general economic conditions and State regulations. So far as increase in price is concerned, it may be said that profit is the excess of sales proceeds over the cost of product. Any increase in price will boost profits. It will be at the highest point where the excess
of revenue over cost is maximum. The technique of cost volume analysis helps the management in determining the effective profit planning and the cost of various levels and contribution of business operations and their effects on earnings. Because of the competitive economy, prices are determined by market forces which would be beyond the control of an enterprise. Even in the oligopolistic conditions consumers’ resistance and State regulations can influence price in the direction quite adverse to the interest of an enterprise. Although the prices affect earnings, the management’s policy to charge high prices is limited. Changes in the prices on the other hand may compel the management to change volume and value of output which in turn affect earnings. Thus, the primary role of cost volume and profit relationship is to pave the way for devising the most profitable combination or maximisation of operating factors which is termed as profit planning.

The basic criterion underlying the use and study of cost volume and profit analysis is that various costs do not respond uniformly to the changes in volume. Certain costs, namely the cost of material, labour, and other expenses which vary directly in proportion to changes in the volume, are called variable costs, whereas the costs like salaries, rent, depreciation, remain fixed or constant without being affected by the changes in volume are called fixed costs. Calculation of earnings starts with computation of marginal income, i.e., net sales proceeds less variable costs. Marginal income is known as gross profit. This is the first index of profitability. In other words profit
is made only when marginal income exceeds fixed cost. The point at which marginal revenue is just equal to the fixed cost is called break-even-point [no loss, no gain]. It is thus clear that even a small fall in volume from an expected level can cause a material drop in marginal revenue and thereby by earnings.

To avoid the evil effects of a change in cost and volume relationship, every enterprise recovers in current assets what it loses in fixed assets without making any profits. Thus the breakeven concept is the convenient means of visualising the situation for the purpose of attaining the projected profits.

It should be remembered that "breakeven analysis represents a short run static relationship of cost to output" and is relevant to the day to day managerial decisions regarding products and pricing policies. In the short run some inputs are fixed in amount and firm can expand or contract its output by varying the quantum of other inputs only. In the long run all inputs are variable. For more profitable use of breakeven analysis, management must know the shape and elasticity of its likely demand curve. The empirical study of breakeven analysis and its impacts on earnings of different corporate units needs a detailed study and cost structure in terms of variable and fixed costs, scale of operational capacities, sales potentiality as well as the minimum amount of earnings which will be regarded to serve the capacity taped from various sources. In the published

* Kuchhal -Financial Management, Page No. 87.
accounts of the companies except the marginal revenue [gross profit] and indirect expenses, all other items are not deductible. We have attempted analysis of facts envisaged from the final accounts and have computed both these items from micro basis and proceeded with the analogy with breakeven point is reached where the marginal income is just equal to the fixed and indirect overheads.

It is noticed that the impact of indirect expenses on gross profit was greater in small and in large companies and than in medium companies perhaps because small companies lacked economies of scale whereas the large companies suffered from excessive capacities. Medium size companies were more efficient companies. Company-wise analysis reveals that the traditional industries like Food, pharma fixed cost take increasing portion of gross profit because of mounting up expenditure, low level of productivity, industrial unrest and under utilization of capacities. For proper accounting of the overheads, it is revealed that the same is attributable to any of these costs and should be calculated separately and charged to factors responsible for them. For example, overhead costs owing to under utilisation and government regulations may be recovered from the subsidies and that by faulty management and industrial unrest being appropriated as an abnormal loss. This suggestion has particular relevance to Indian companies where companies often worked under capacity because of strikes and lockouts, government controls, non-availability of raw materials etc.
OPERATING LEVERAGE AND FINANCIAL LEVERAGE:

The Concept of Leverage:

This concept considers the proper mix between equity and debt. In the process of selection of debt equity mix, the firm analyses a number of factors. One such factor is consideration of leverage. Capital structure decision involves a choice between risk and expected returns. Use of more and more debt capital raises the riskiness of the firm’s earnings stream but it tends to provide a higher expected rate of return to the shareholders. The term leverage refers to an increased means of accomplishing some purpose. With leverage, it helps us in lifting heavy objects, which may not be otherwise possible. It is used to describe the firm’s ability to use fixed cost assets or funds to magnify the return to its owners. In business, leverage is the means of increasing profits. It may be favourable or unfavourable. The leverage of a firm is essentially related to a profit-measures, which may be a return on investment or on earnings before taxes. It is an important tool of financial planning because it is related to profits. *James Horne has defined leverage as "the employment of an asset or funds for which the firm pays a fixed cost or fixed return". Thus according to him, leverage results as a result of the firm employing an asset or source of funds which has a fixed cost [or return]. The former may be termed as fixed "operating cost", while the latter may be termed as "fixed financial cost". It should be noted that fixed cost or return is the function of

* M.Y. KHAN, P.K. JAIN
[FinancialManagement Page No. 433]
leverage. If a firm is not required to pay fixed cost or fixed return, there will be no leverage. Since fixed cost or return has to be paid, the size of such cost or return has considerable influence over the amount of profits available for the shareholders. When the volume of sales changes, leverage helps in quantifying such influence. It may therefore be defined as relative change in profits due to change in sales. A high degree of leverage implies that there will be a large change in profits due to a relatively small change in sales and vice versa. Thus, higher is the leverage, higher is the risk and higher is the expected return. The term risk implies the degree of uncertainty the firm has to face in meeting fixed payment obligations and fixed costs and cost of debt capital.

There are two types of leverage used in business terminology - i) Operating leverage, and ii) Financial leverage, and the leverage associated with investment [asset acquisition] activities is referred to as operating leverage, while leverage associated with financing activities is called the financial leverage. We are basically concerned with financial leverage for purposes of the financing decision of the firm, the discussion of operating leverage is to serve as a background to the understanding of financial leverage because the two types of leverage are closely related. Operating leverage is determined by the relationship between the firm's sales revenue and its earnings before interest and taxes [EBIT]. The earnings before interest and taxes are also generally called as operating profits. Financial leverage represents the relationship between the firm's earnings
before interest and taxes [operating profits] and the earnings available for ordinary shareholders. The operating profits [EBIT] are, thus, used as the pivotal point in defining operating and financial leverage. Operating and financial leverage represents in the process of determining the earnings available to the equity holders.

[i] Operating Leverage:

The operating leverage takes place when a change in revenue produces a greater change in sales on operating income. A firm with a high operating leverage has a relatively greater effect on [EBIT] for small changes in sales. A small rise in sales may enhance profits considerably while a small decline in sales may reduce and even wipe out the EBIT. It is always safe for a firm to operate sufficiently above the break-even-point to avoid dangerous fluctuations in sales and profits. The operating leverage is related to the fixed cost. The firm is said to have a high degree of operating leverage if it employs a greater amount of fixed costs and small amount of variable costs. On the other hand, a firm will have a low operating leverage when it employs a greater amount of variable cost and as smaller amount of fixed costs. Thus the degree of operating leverage depends, upon the amount of fixed elements in the cost structure. Operating leverage in a firm is the function of the amount of fixed costs, the contribution margin and the volume of sales. The operating leverage can be calculated by the following formula.
Operating Leverage = \frac{Contribution}{Operating profit} \\
Or \quad = \frac{C}{OP}

Operating profit means "earning before interest and tax" [EBIT]. Operating leverage may be favourable or unfavourable in case the contribution [i.e., sales less variable cost] exceeds the fixed cost, there is favourable operating leverage. In the reverse case, the operating leverage will be termed as unfavourable.

[ii] Financial Leverage:

The Financial Leverage can be contributed to the profitability of an enterprise by resorting to an optimum capital structure or debt equity ratio. An efficient management can reduce the cost of capital and taxability and consequently increase dividend and retain earnings. Leverage makes for the conditions in which the rate of interest on borrowings, the company is called highly geared, and in the reverse case it may be called low geared.

An American Financial Expert, Modigliani and Miller advance the Theory [generally referred to as M.M. Proposition] that "the average cost of capital to the firm depends on its capital structure." In contrast to the traditional view, they highlighted that the advantages of debt financing are quite small, because of adverse effects of debts on the
market value of shares. In these formalities leverage is defined as debt dividend by market value of shares and earnings. Price ratio has been shown as linear function of leverage. * 

It may be pointed out that the M.M. Proposition is based on a static approach. In concentrates on equilibrium where there is no choice between debts and equity. Costs of funds from all sources are equal and taxes as well as floatation expenses are absent. Surely the M.M. approach to the cost of capital is a long-term phenomenon which can be worked in a perfectly competitive economy where all investors including institutions and government agencies act rationally. But in practice the markets are never in equilibrium, hence "the hypothesis of independence between average cost and capital structure appears untenable. * 

Financial leverage occurs when a corporation earns a bigger return on fixed cost funds than it pays for the use of such funds. It refers to a situation in which a firm has fixed charges, securities such as preferred stock and debentures, and its return on investment must not be equal to fixed charges. In other words, if the return on investment exceeds the rate of interest, a firm has a favourable financial leverage and is in a position to pass

* Alexander and Burges - Effects of Capital Structure on Cost of Capital, Page No.103.

* Modigliani and Miller - Cost of Capital
part of this advantage to its equity stockholders by resorting to borrowings. Financial leverage results from the presence of fixed financial charges in the firm's income stream. These fixed financial charges do not vary with the earnings before interest and tax [EBIT] or operating profits. They have to be paid regardless of the amount of EBIT available to pay them. After paying them, the operating profits [EBIT] belong to the ordinary shareholders. Financial leverage is concerned with the effects of changes in EBIT on the earnings available to equityholders. Financial leverage involves the use of funds obtained at a fixed cost in the hope of increasing the return to the shareholders.

However, when the ROI [return on investment] exceeds interest rate, the financial leverage is favourable, or the firm is said to be "trading on equity". On the other hand unfavourable or negative financial leverage occurs when the firm does not earn as much as the fund's cost, or when the ROI [return on investment] is less than the interest rate, the firm loses money by its borrowings. It is not then worthwhile for it to borrow and have an unfavourable financial leverage. Thus, financial leverage is based on the assumption that the firm is to earn more on the assets that are acquired by the use of funds on which a fixed rate of interest/dividend is to be paid. The difference between the earnings from the assets and the fixed cost on the use of the funds goes to the equityholders. The concept of
financial leverage is a significant one because it has direct relation with structure of management. It determines the relationship that should exist between the debt and equity securities. A firm which does not issue fixed-charges securities has an equity capital structure and does not have any financial leverage. The process of using debt capital to increase the rate of return on equity is also referred to as trading on equity. Borrowing is done by a company because of the financial advantage that is expected from it. The use of borrowings for the purpose of such advantage for residual stockholders is also called "trading on equity" or leverage. Thus, trading on equity is defined as the increase in profit return resulting from borrowing capital at a low rate and employing it in a business yielding a higher rate. The capital obtained from debt securities is used in a project which produces a rate of return which is higher than its cost. This allows the difference to be distributed to holders of equity securities. In other words, if a firm can obtain debt funds at an interest rate lower than its internal rate of return, this should tend to increase the rate of return on its equity capital. This is known as the principle of financial leverage on trading on equity. Thus, when a corporation earns more on its borrowed capital than the interest it has to pay on bonds, trading on equity
is profitable. But when the interest on bonds amounts more than the company makes from the use of these funds, trading on equity is unprofitable. For these reasons, it is said that trading on equity magnifies profits and losses.

There is no hard and fast rule as regards the capital-gearing but the general principle to be kept in mind is that the raising of debts for company creates some risk for the shareholders because the payment of interest and redemption of loans are given priority over the claims of the shareholders. Hence the rate of interest should be lower than that of the dividend. Debt should result into increasing earnings per share, so as to compensate the shareholder for additional risk. Heavy and disproportionate indebtedness, specially in respect of business units operating in the industries characterised by general instability to avoid the adverse circumstances. The debts should be kept within reasonable limits, taking into account the quantum and rate of earnings, liquidity position and the rate of capital formation of an enterprise. Ordinarily the ratio of 1:1 is considered good. Further, in case of risky projects it is desirable that the equity should be more than debts. However higher proportion of borrowings should not be taken as an unsatisfactory state of affairs for the undertakings which are run efficiently by the competent and manufacturing basic products enjoying definite and assured demand.
Debt Equity Ratio:
Table No.2.1 shows the trends in borrowings and debt equity ratio in respect of Companies included in the study. It is observed that debt equity ratio of small companies travelled downward from 1985-1990. Industry-wise analysis reveals that this ratio was the lowest in tea industry and fluctuated from 0.162 to 0.107. In all the cases, the degree of dependence on debt financing kept increasing continuously from 1985 onwards. Companies have not crossed the limit of 1:1. They have been acting over cautiously as can be seen from the Table. Medium Large Companies kept their borrowings much below between the limit, whereas the small companies touched the upper limit. Debt equity ratio of all the companies put together was in complete conformity with that of large companies.

Financial Leverage and Tax Liability:
The importance of Financial Leverage has increased because of provision on Income Tax Act wherein taxable income is computed by allowing various expenses including the interest paid or accrued from the gross profit. It is the inclusion of interest as an expense for income tax purposes, which complicates the effect of leverage financing, distinguishes further between the effects of debt leverage and priority or equity leverage and in general, and raises hope with the otherwise sound business judgement. This, as a matter of fact, is myriad of incentives in which the income tax cost be taken into account in reaching business decisions. Thus, income tax provisions act as an incentive to greater

reliance on borrowings. Management cannot afford to neglect the
tax effectiveness of the alternative solutions to the financial
problems, specially when the tax rates very high. Too often, the
tax cost of doing the proper thing from the sound policy point of
view is so great that it may tempt the management to move even in
unsound direction just to keep the cost of capital at the minimum
level. It is very widely held that the present tax system tends
to cause a dilution in the capital structure of modern business
organisation as debt financing has to be preferred to equity.

To what extent the corporation units covered by these survey
benefited from the leverage financing in reducing the tax
liability and enhancing their distributable earnings can be
studied from the financial figures appearing in Table 2.1.
Savings in tax liability has been calculated with the help of the
following formula:

\[ TS - TZ - TD \]

Where TS is saving in tax liability. TZ is tax liability at zero
debt [presuming that the entire capital employed to be the share
capital and earnings before tax and interest as the taxable
income]. Thus, TZ is equal to earnings before interest and tax,
multiplied by effective rate of tax. TD is actual tax paid.

Contribution of tax saving to distributable earnings has been
measured by comparing two important ratios. They are, divisible
earnings, net worth ratio and divisible earnings at zero debt to
capital employed ratio. Excess of divisible earnings to net
worth over divisible earnings at zero debt capital employed is
direct contribution of the financial leverage. Our findings are as follows:

1] Financial Leverage results into savings in tax to the extent of 3.71 crores in 1985 and the same amounted to Rs.8.95 crores in 1990 in respect of all companies. This led to a decrease in the divisible profits. However, the earnings per share have increased. Downward trend in the tax saving ratio reveals that the Government also has been a beneficiary of debt financing of the corporate sector. A considerable amount ranging from Rs.0.72 crores to Rs.4.64 crores resulted in the decrease in the divisible profits caused by trading on equity. [Table No. 2.02].

2] In the case of small companies tax savings attributable to trading on equity varied from 0.03 crores in 1985 to Rs.0.61 crores in 1990 and witnessed mixed trends. [Table No.2.03] In all the years except in 1990, debt financing enhanced the profit net worth ration to the extent of 4.38 crores in 1990 from 6.43 crores in 1986. Whereas in the aforesaid years it caused a nominal decrease. This shows that because of uncertain and lower profitability the small companies could not benefit from the debt financing. [Table No.2.03].

3] Financial Leverage in medium companies results into saving in the tax liability ranging from Rs.0.08 crores in 1985 to 1.25 crores in 1990. [Table No.2.04].

4] As regards large Companies, debt financing could decrease their tax liability to the extent of Rs.0.60 crores in 1985 to Rs.2.77 crores in 1990. [Table No.2.05].
It is thus obvious that the leverage play a very important role in the determination and distribution of earnings. Management can do away with the adverse effects of corporate tax, through and adequate debt financing and at the same time can increase the rate of dividend and earnings per share to a considerable extent.

Conversion of Loans into Equity:
With a view to curbing the tendency of disproportionate indebtedness of the corporate sector, the Government of India has been empowered to direct the public companies to convert their loans to equity, vide section 81 of the Companies Act 1956. The Mahalanobis Committee on "Distribution of Income and Levels of Living" was the first to observe that cheap financial assistance rendered by public institutions has contributed to the growth of corporate sector and encouraged inter-corporate investments and expansion of financially unsound undertakings. Till recent past, no such powers were exercised. A move to convert loans into equity has been gaining ground after the publication of Licensing Inquiry Committee [known as Datta Committee] Report, 1969, which pointed out that the institutional financing facilitated the disproportionate growth of big business houses. The Government of India has laid down guide-lines for the conversion of loans into equity. Financial institutions like IFC, ICICI, UTI, LIC and IDBI have converted their term-lending into equity in a good number of public sector undertakings. Critics of conversions of loan into equity dubbed it as a discreet method of Government getting control over private sector through financial institutions which may lead to a back door nationalisation, i.e., liquidation of private sector.
The idea of conversion of loans into equity, so far as it is based on the rationale that the lending agency should share in the prosperity of borrowers by assuming responsibility of direct participation, can be appreciated, provided this does not encourage irresponsible debtors who pay ducks and drakes with the institutional fund, and at the same time it is fair to existing shareholders. This will fill the gap created by the abolition of Managing Agency System.

Income smoothening means "stabilising or levelling the fluctuations".* In periodic earnings the motivation for income smoothening comes from the progressive income tax in the case of individuals and partnership firms. But in the case of corporation it is quite different because of less progressive corporate tax, advantages of saving in tax are not available except in the distinct of stable earnings. The desire to maintain good relations with the investors and the workers compels the management to do away with **. A sharp rise in the earnings may induce the workers to demand increase in their wages which may lead to industrial unrest or rise in cost. On the other hand a steady decline in earnings may shake the confidence of the investors. Thus, income smoothening may help management, in the practice of a stable dividend policy.

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** Peaks and Valles-H and SR- Page No. 21-30.
The accounting techniques and managerial practices which aim at earning smoothening can be enumerated as

1. Inter period shifting of revenue and expenses,
2. Deffering the revenue charges as capital expenditure and intangible assets,
3. Changing the method of valuation of stock,
4. Creation of Reserve.

1) Inter period shifting of revenue and expenditure:

Inter period shifting of revenue can be attained by speeding up or delaying the shipment or billing of the products with the help of the process of planning and budgetary control. Management can correctly forecast the results of its operation in two accounting periods and can shift the revenue accordingly. In service industries, where the direct costs are relatively much smaller, the effect of shifting of revenue may become more significant than in manufacturing and mechansing enterprises. Though in many cases the only transaction occurring relatively near the closing dates would be susceptible to such shiftings. The management can use realistic and logical methods of gross revenue booking during the whole accounting period and within limits can postpone sales and revenue by delaying the execution of orders and can speedily start earnings by completing deals which otherwise management would have completed in some future accounting period.

The practice of shifting expenditure is quite easy. Management can increase the earnings by postponing the expenditure from one period to another and likewise reduce
the earnings by incurring huge expenses in advance. The expenses which can easily be shifted at the discretion of the management are repairs and renewals, advertisement, scientific research and the like.

2) Deferred Revenue Charges as Capital Expenditure and Intangible Assets:

Intangible assets refer to fictitious assets like prepaid expenses, advertisement expenses, trade marks, goodwill, etc. which are generally capital expenditure and retained as assets for some times and written off in easy instalments as the basis for the period of the usefulness and availability of surplus revenue at the discretion of management. Here the management possesses powers and can ultimately accumulate correct expenditure in deferred or capital expenditure account, accounting during bad years and liberal amortisation in the years of high revenue. But the corporation tax laws expressly disallow the deduction of deferred revenue expenditure as well as capital expenditure in respect of intangible assets.

3) Changing the method of valuation of stock:

Different methods of valuation of stock offer a considerable latitude to the management for smoothening the earnings. Traditionally stock is valued at cost or market price or at either cost or market price whichever is less. Recently, some more methods of valuation of stock like FIFO or LIFO have been devised, which help the management in
matching the current cost with current revenue. Each of these methods, if used and changed at the discretion of the management, possesses distinctly the great advantage of stabilising effects on earnings. Other less significant methods arise through the subjective decisions made by the management in respect of valuation of unsaleable stock and absolute or damaged goods where adjustments of time can also be produced for smoothening the effect on earnings. But the provision of Income Tax Act, by insisting upon proper and constant method of valuation of stock, has curbed the management’s power of manipulation. It has laid down that once a particular method is selected it must be consistently followed from year to year. Only a justifiable change is permissible with the prior consent of the Income Tax Authorities. Precautionary reserve for anticipation in value of stock is not permissible, and any unrealised loss cannot be set off against the profits of current year.

4] Creation of Reserves:
Historically, the creation of reserves for various contingencies and unrealised losses has proved an effective device for profit stabilization. War and post-war period produced a tremendous increase in the use of reserves providing for intangible future events, namely general contingencies and possible future inventory losses. Fortunately, such crude and arbitrary techniques are rarely used in the concerns of public interest. Corporation tax
laws do not recognise the creation of reserves. Provisions of Income Tax allow the actual amount of loss as deduction from the main earnings. All such reserves are taken as part of retained earnings without affecting the quantum of taxable earnings.

Thus, the techniques of earnings smoothening, except in the case of shifting of main revenue and expenditure, are of less importance so far as the determination of earnings is concerned. The tax and corporate laws provide effective checks on managerial discretion coming in the way of true and fair disclosure of earnings by the final accounts. It is difficult to locate the impact of such practices empirically on the basis of published accounts.

5] Depreciation and Development Reserve :

Depreciation is a live question, like taxes it is present in every sphere of economic life. Being extremely "dynamic" and "ubiquitously important" it affects costs, prices and profits of an enterprise and thereby management, Government, Shareholders, employees, creditors and consumers. In making decisions regarding costs and prices of products, determination and distribution of earnings, tax liability, replacement, modernization and expansion, the management must take into consideration depreciation. Any calculation without depreciation is misleading and vitiates the true and fair view of the company's state of

*Bhushan B.S.N. Depreciation, Why is it so important? Integrated Management, Page No.44.
affairs. Government has to think about the rate and method of depreciation, while formulating legislative and administrative policies regarding levy of tax on earnings. Depreciation is a matter of great concern to the shareholders. They are interested in ascertaining the true and fair profit or loss and economic viability of their companies. Depreciation can make or mar this picture. Depreciation is important for creditors, when they take the decision to advance or not to advance funds requested by the companies. Depreciation is an important element of cost entering into the price of products. Consumers as a class are also interested in the impact of it on prices. Charge for depreciation also affects the managerial personnel and workers, when they are paid commission and bonus on the net earnings, after an adequate provision for depreciation is made.

CONCEPT OF DEPRECIATION:
Depreciation is derived from a Latin word ‘de-pretium’ which means decline in practice. The concept of depreciation is closely linked to the concept of business income. In the revenue generating process the use of long term assets tend to consume their economic potential. At some point of time these assets become useless and are disposed off and possibly replaced. The economic potential so consumed represents the expired cost of these assets and must be recovered from the revenue of the business in order to determine the income earned by the business.
Therefore, depreciation may be defined as that portion of the cost of the asset that is deducted from revenue for assets services used in the operation of a business. The cause of depreciation is wear and tear, exhaustion, obsolescence, efflux of time, accident. There are four distinct meanings currently attached to the term.


The popular concept is that depreciation is a decrease in the value while the accounting concept implies that it is an amortized cost. Appraisal concept indicates that it is a differential value between the existing old asset and hypothetical new asset taken as a measure of comparison. According to economic and engineering concept it is a physical and mechanical process.

In order to have a clear understanding about the concept of depreciation, it will be useful to quote definitions given by some prominent authorities.

* According to Pickles "depreciation is the permanent and continuing diminution in the quality, quantity or value of an asset."

The Institute of Chartered Accountants of England and Wales defines depreciation as "that part of cost of a fixed asset to its owner which is not recoverable when the asset is finally put out of use by him. Provision against this loss of capital is an integral cost of conducting the business during the effective commercial life of the asset and is not dependent upon the amount of profit earned."

According to the Institute of Chartered Accountants of India, "depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes. . . . . depreciation is allocated so as to charge a fair proportion of depreciable amount in each accounting period during the expected useful life to the asset. Depreciation includes amortisation of assets whose useful life is predetermined."

From the above definitions, it can be concluded that depreciation is a gradual decrease in the value of an asset from any cause.

**Depreciation on Replacement Cost**

In recent years, there has been a lot of controversy regarding charging of depreciation on historical Vs. replacement cost of the asset. It is being argued by the protagonists of 'replacement cost' that since one of the major objectives of providing depreciation is to provide enough funds for the replacement of an asset at the end of its useful life, it will be

* S.N.Maheshwari [Management Accounting & Financial Control] Page No.35.
appropriate to provide for depreciation on the replacement cost of the asset rather than on its historical cost. This is particularly true in the context of present inflationary conditions. If depreciation is charged on the basis of historical cost, there will not be enough funds to replace the asset at the end of its useful life on account of substantial increase in the price of the new asset to be purchased for replacing the old asset. Thus, they argue that the very purpose of providing depreciation is completely defeated if the depreciation is charged on the basis of historical cost of the asset.

There is considerable strength in the arguments put forward by the protagonist of charging depreciation on the replacement cost. The following are the practical difficulties in adopting this approach.

1] It is difficult to estimate the replacement cost well in advance. The cost can be correctly known only when the asset is replaced.

2] The new asset purchased for replacing the old asset is always of a better type in respect of its quality as well as efficiency. Of course, one has to pay more for the new asset, but the profitability of the business also increases an account of new and better quality of the asset. In case depreciation is charged on replacement cost, depreciation is charged for the improved asset even when such asset has not been used for generating revenue during those years.
3] Income tax authorities do not give recognition to the concept of charging depreciation on replacement cost.

4] Under the Companies Act, depreciation is to be charged only on original cost of the asset. Any profit or loss made on scrapping the asset over its book value should be credited or debited to the profit and loss account of the year in which the asset is scrapped.

5] Businessmen favour charging of depreciation on replacement cost under inflationary conditions. It is doubtful whether they would favour charging lesser depreciation on the periods when the prices are falling.

On account of the above practical difficulties, it will be advisable to charge depreciation on the historical cost of the asset. However, in case it is desired to provide enough funds for replacement of the asset at the end of its useful life, following step may be taken.

1] A "replacement reserve" may be created in the books of accounts of the business. The additional amount required for replacing the asset over and above the original cost of the asset may be estimated. Every year an appropriate amount may be transferred from the profit and loss account besides usual depreciation on the asset to provide for additional amount required for replacement of the asset over and above the original cost of the asset. It may be debited to the profit and loss appropriation account and credited to the replacement reserve account.
2] The replacement reserve account should be credited every year with interest at the current rate on the accumulated balance standing to the credit of this account.

In case, the above procedure is followed, the business will have sufficient funds to replace the old asset by a new one as and when the necessity arises.

i. Depreciation and Management Decision:
Depreciation is of particular significance in three decisions are:
1] Decisions relating to income measurement and the impact of inflation.
2] Decision to income tax determination.
3] Decision relating to investment of capital.

ii. Depreciation and Income Measurement:
The net income earned by a business is determined by charging operating costs against the revenue of the period. Depreciation is a significant part of the operating cost of the business. Since operating costs are significant for business decisions, management has to take into account the impact of depreciation charge on the business income. The choice of the method of depreciation is to be made on the basis of the profitability of assets, the method selected should indicate the characteristics which are similar to cash flow. In case equal sums are expected every year, the straight line method may be appropriate. The straight line method will not be appropriate in case the argument that, a rupee saved today is much more important than a rupee saved
in future, is accepted. This is because the rate of depreciation under straight line method is usually lower than that under the diminishing balance method. In such a case, diminishing balance or any accelerated method of depreciation would be more appropriate than the straight line method.

iii. Depreciation and Impact of Inflation:
In periods of inflation, any depreciation method based on historical cost will result in a lower charge for depreciation than what is desired. In order that imported income is correct and sufficient and funds are available for replacement of an existing asset, the management should make appropriate adjustment to restate depreciation and income in terms of replacement cost of the assets.

iv. Depreciation and Income Tax Liability:
Income tax provisions, have probably the strongest effect on depreciation policy pursued by a firm. In case the objective is to charge higher amount of depreciation in the initial years, to make more funds available for investment by effecting saving in tax liability, accelerated depreciation method would be more suitable. However, if there is reason to believe that income tax rates will be higher in the future, it may be better to take smaller depreciation deductions in the present so that larger deductions are available in later years. Thus, the decision will depend upon the return that can be earned from available resources as compared with anticipated future tax savings.
v. **Depreciation and Capital Investment Decisions:**

An investment made in a fixed asset is a sunk cost. Hence, any depreciation on an existing fixed asset is of little significance while making capital investment decisions. However, the amount of chargeable depreciation is significant to the extent it affects the probable cash flows from a particular investment project. Depreciation does not directly generate cash but it is an expense which is deducted for arriving of taxable income. Thus, depreciation indirectly generates cash by reducing the current taxable income. Since most of the investment decisions are made on the basis of rate of return calculated according to net cash flow [and not net income] from the project, depreciation does have an impact on capital investment decisions.

**Selection of a Depreciation Policy:**

The management has to adopt a suitable depreciation policy keeping in view of the following objectives:

i] Recovery of the original investment, i.e., the acquisition cost of the asset before the expiry of the economic life of the asset.

ii] Ensuring uniform rate of return on investment.

iii] Generating sufficient funds for the replacement of the assets after the expiry of their economic life.

iv] Deriving maximum tax benefit.

v] Ascertainment of correct profit or loss.
The above objectives can be considerably achieved if the management takes care for the following aspects in framing its depreciation policy:

i] Selection of an appropriate method. The management should select an appropriate method keeping in view the nature of the asset and the prime objective of the management.

ii] Periodic review of the provision. The choice of the method determines the amount of depreciation and the mode of its recording. However, the management must review periodically whether the provision for depreciation which is being made is proper or not. Any under or over provision in the context of changed circumstances should properly be adjusted in the books of accounts.

iii] Evaluation and disclosure of depreciation policy. The depreciation policy being followed by the business should be evaluated in the context of tax incidence, price level changes, government regulations, etc. The effect of any change in the depreciation policy in an accounting period should be quantified and disclosed in the financial statements of the business.

**Estimated Life of Assets:**

Estimated life during which 95% of the cost of the assets could be written off varies from 58 to 118 years for buildings, 18 to 28 years for furniture and 8 to 28 years for plant and machinery. The estimated lives of the similar assets in U.S.A. as calculated...
by Srhi Ved Prakash Gandhi of the Indian Institute of Management, Ahmedabad, work out to be 40 to 60 years for buildings, 10 years for furniture and 6 to 22 years for plant and machinery.* Thus, the official estimates of the life of the asset in India are much higher than that in the U.S.A. This is in view of the extra shift allowance and liberal tax treatment of the scrap value of the plant under the title of terminal depreciation. It can be said that in India the depreciation is directly linked with the physical life of the assets. There is no limit for the carry forward and set off for depreciation. Unabsorbed depreciation can be deducted from the taxable income in any future year, provided the same business is carried on.

Companies Act 1956 was amended in 1988, wherein it introduced Schedule XIV to the Act. Schedule XIV specifies rates of depreciation on all assets like plant, machinery buildings and furniture. Thus the rates of depreciation which were hitherto linked to income tax rates of depreciation, have been now, since 1988 delinked. Depreciation as specified by Income Tax Rates 1962 are to be applied for income tax purposes only and depreciation rates given by Schedule XIV are to be followed while preparing the balance sheet of the company.

For this empirical study, Schedule XIV rates are not used since the period to which the data relates is prior to amendment to the Companies Act in 1988.

Empirical Study of the Depreciation Allowance:

i] Depreciation to operating expenses ratio:

Financial figures appearing on Table No.2.06 present a vivid picture of the trends in depreciation allowance in respect of companies included in the study. It is observed that the depreciation to operating expenses ratio varied from 40.61% [1989] to 50.00% [1990] in case of small companies, from 37.56% [1990] to 54.26% [1989] in medium companies and from 30.92% [1986] to 55.71% [1985] in large companies.

Taking all the companies together, this ratio was found to be fluctuating between 33.95% [1986] to 53.93% [1985]. It is thus obvious that the medium and large companies charged more depreciation perhaps because of huge base of fixed assets.

ii] Depreciation to earning before tax and depreciation ratio:

While comparing depreciation with the earning after tax but before depreciation, it is found that the depreciation provision took away most of the earnings in the case of all companies included in this study.

iii] Depreciation Fixed Asset Ratio:

The total amount of depreciation provided out of the current profits worked out between 7% and 9% of the fixed assets every year, on an average and the same should not be taken as unsatisfactory one.
It is thus found that the provision for depreciation influences the taxable earnings as well as the distributable earnings and to a greater extent the working capital of the corporate sector.

Critical Appraisal of the Government Policy:
The depreciation policy of the Government of India has been criticised on a number of grounds from time to time. It is argued that the depreciation allowance is provided on unrealistic rates without considering the economic life of assets and technological changes. Salvage allowance at the rate of 5% is quite inadequate, as it unnecessarily enhances the estimated life of the assets. Government appointed the Bhoothalingam Committee to suggest measures for rationalisation and simplification of the tax structure. As regards depreciation, the Committee suggests that there should be only four broad categories of the assets and four depreciation rates 5%, 10%, 15%, and 20% respectively. Extra shift allowance should be abolished and the depreciation allowance continued on the written down value.

After considering these suggestions, the Government of India has abridged the existing 17 categories of plant and machinery into 7 and announced the revised rate of depreciation allowance viz. 5%, 10%, 15%, 20%, 30%, 40% and 100% respectively. These new rates have been made effective from the financial year 1969-70.

The commendable features of the new depreciation rates are:
i) Abridgement

ii) Simplification
iii] Provision for allowing full depreciation at prescribed rate for any period of use, however short that may be during the year. But a minimum rate of 5% for plant and machinery falling in the first category is quite meager and not understandable. The minimum rate should have been not less than 10%. As regards the abolition of the extra shift allowance, as recommended by the Bhoothalingam Committee, it may be pointed out that the same will be disastrous for the mass-production industries, which utilize the plant on three-shift basis. At the same time it appears to be unscientific to allow full depreciation even for a shorter period of use.

The development rebate has been an effective instrument, ensuring the generation of internal resources in the corporate sector. Corporate units have to retain statutorily, at least 75% of the amount of rebate for a period of 8 years, which otherwise would be liable to be paid as corporation tax or withdrawn as dividend. The Bhoothalingam committee opined that the liberal allowance of the development rebate tended to a less careful use of resources resulting into over-capitalisation and huge blockade of funds into fixed assets. The committee recommended abolition of the same and suggested that the original cost of the assets be raised to 120% for the purpose of depreciation allowance so as to meet the over-increasing costs of replacement.

The Central Government has given an advance notice for the withdrawal of the development rebate vide the budget provisions.
for the year 1971-72. Accordingly, rebate would not be available on the ship and plant installed after May 31, 1974. Nothing has been said for the replacement allowance. Discontinuance of the development rebate would mean that the industries will be deprived of the substantial internal resources so essential for the industrial development. It will increase their tax liability to the extent of 55% of the present allowance, thereby reducing the quantum of ploughed back profits. It will hurt the small companies most. The advance notice of withdrawal after 1974 is likely to accelerate the investment before that date and may lead to retardation of the same thereafter. Thus, the withdrawal of the development rebate appears to be a dramatic measure of compel the private sector to invest and act now.

One cannot rule out the need for providing incentives to growth, employment generation and production of mass consumption and basic capital goods. Government should formulate a long term strategy for the economic development of the nation and announce its tax policy for a period of 5 to 10 years in advance. India has to go a long way before it can achieve an adequate industrial base and take off stage of growth. Government should come forward with an effective and adequate relief measure in place of development rebate without any lapse of time. Otherwise, the corporate sector will be deprived of the statutory savings which have stood the companies well in good instead during the adverse conditions like the non-availability of funds and unfavourable market conditions. There is a dire need for an incentive to modernize and effect optimum utilisation of the productive
capacities of the traditional as well as new industries. An ideal and the most suitable system of providing such an incentive would be one where the rebate is exclusively linked with productivity, so as to discourage redundant expansion. It is therefore suggested that the present development rebate should be continued as the production rebate. Recently, the Wanchoo Committee on taxation has also suggested a similar allowance to boost the production in the industrial sector of the country.

Corporate Taxation:

Corporate taxation is the most important and forceful tool of fiscal policy. On the one hand, it helps the Government in realising the revenue and on the other, it assists in achieving various socio-economic objectives. The prime function of taxation in the inflation-bound developing economy like India, is to curtail private consumption and make more funds available for the industries. This principle of taking the private individuals is not wholly true in the case of corporations. Entire tax money, if left with the corporation themselves, would not be distributed as dividends, nor would the whole amount of dividends received by the shareholders spent for private consumption. Corporations are able to effect the productive use of their earnings.

About half a century ago, economists simply shuddered at the very thought of the corporation tax. However, now it has become a regular and indispensable feature of tax system in all the modern countries. Government prefer corporation tax to other taxes because it brings in large sums of money and that too with less
pain to the tax-payers. It is difficult to avoid and evade the corporations tax. Politicians are under a great temptation to increase the corporation taxes. In present day economy, corporation play a very important role in the economic life of a nation and taxes have become a major factor affecting their working. The taxable capacity of corporations tends to increase in an expanding economy like ours. Inflationary pressures and scarcity conditions provide better chances of repaying high profits. High profits are bound to attract higher rages of tax in a socialist democracy. Further, the corporate earnings are the joint product of the community and can be taxed at a higher rate without any direct and personal sacrifice. But unduly heavy tax retards the economic growth in a variety of ways and adversely affects the will to save and the capacity to invest. A corporation ought to be so conceived and applied as to cause the minimum ill effects on the functioning of the corporate sector in particular, and the economy as a whole. With the passage of time, corporations tend to develop anti-social tendencies like monopolistic trade practices and massive concentration of economic power in the hands of a few. Hence, the possibility of the misuse of the huge financial and other resources has considerably increased. Corporation tax is one of the tools for checking the evil effects of such practices.

Taxes on corporate earnings create two problems. Firstly, taxes skim away much of the earnings that would have been used to pay dividends. Secondly, when corporation does not have sufficient liquid funds, it has to borrow to meet the tax liability. This
happens in periods of rising prices when corporations need to invest more and more capital in the fixed and current assets. However, when a particular tax has been in effect for a period of time, it becomes convenient for the management to adopt its policies in accordance with tax liability.

**Concept of Company:**

For the purpose of corporation tax, the connotation of company is wider than that given in the Companies Act. In the companies are classified on the basis of residence, nature of business, substantial public interest, and arrangement for declaration of dividend. Liability for corporation tax varies with each class of companies. According to section 2(26), Indian Company means:

a] a company formed and registered in India under Indian Companies Act 1956;

b] a company formed and registered in India under any law relating to companies formerly in force in any part of India except Jammu and Kashmir;

c] any company formed and registered in Jammu and Kashmir under any law for the time being in force in that State;

d] in case of any of the former union territories of Dadra, Nagar Haveli, Goa, Daman and Div and Pondicherry, a company formed registered under any law for the time being in force in that union territory.
A company which has been incorporated in India or its registered office is in India, is called an Indian company. An Indian company can never be a nonresident company, whereas a foreign company may become a resident company for a particular year if the control and management of its affairs are wholly situated in India in that year. In the case of a resident company the total world income becomes taxable whereas in the case of a nonresident company only the total Indian income is taxed. Resident companies are further categorised as i) companies in which the public is substantially interested and ii) companies in which the public is not substantially interested. Companies falling in the first category are called widely-held companies and those in the second category, the closely-held companies. A widely-held company means company which is either owned by the Government or at least 40% of its share capital is held by the Government or public financial institution or it is a public company whose shares are quoted on a recognised stock Exchange. All other companies are called closely-held companies. The Finance Act 1966 charged the widely-held companies with a condition of prescribed arrangement for the declaration of dividend. Accordingly, companies are required to declare dividend to the extent of the statutory percentage of their divisible profits. Companies are also classified as manufacturing, trading or investment companies, if not less than 51% of their income is directly attributed to any of these businesses.
Taxable Earnings

Corporation tax in India is levied on total earnings excluding the income from agriculture, which are attributable to preference and equity shareholders of a company. Taxable earnings are very broadly computed with reference to the nature of business of the companies. The actual expenses incurred are generally allowed except those which are considered unreasonable and expressly disallowed. The value of tax concessions is deducted while computing taxable earnings. Any gain resulting from the sale of assets at a price exceeding written down value, but less than the original cost, is taxed as 'balancing charges' along with the regular. Income from capital gains arising from the transfer of capital assets at a price more than the original cost are taxed under a separate head as 'capital gains.' The particular feature of the corporation tax is that unlike most of the assess, corporation incurs tax liability on its income, howsoever small the figures may be. There is no minimum exempted income.

Incentives and Concessions

Incentives and concessions have a great bearing on the ultimate tax burden and serve to alter the effective rate substantially. On an average, the present rate of tax comes to be 55% to 65%. The extent to which the tax liability of the corporation was lower than this rate, measures the value of the concessions. The main objectives of incentives and reliefs may be enumerated as i] encouragement to private capital formation i.e. saving and investment in proper direction, ii] floatation of new undertakings, iii] increasing the efficiency and productivity
and the like. Some of the important statutory tax concessions are discussed below:

1. **Exemption to New Undertakings**

   This is the most important tax concession granted to new undertakings for a period of first 5 years. This period is of 7 years in the case of co-operative societies. Profits equal to 6% of the capital employed are completely exempted from corporation tax. If the profits fall short of the amount of thin concession, this unabsorbed amount can be carried forward for 8 years. Dividends paid out of such profits are also exempted in the hands of shareholders. From the financial year this exemption would be computed on shareholders' fund. Debentures and long term loans will be excluded from the capital employed. It is feared by the industrialists that the change brought by the Finance Act, will adversely affect the new undertakings as the same will reduce the tax concession to half or less than half of the present level. However, this benefit is now withdrawn.

2. **Tax Concession to Small Companies**

   The concept of small company with an income not exceeding Rs. 25,000 was first introduced by the Finance Act, 1948, and the income tax was levied at the rates half of that for other companies with the income exceeding this limit. This resulted into great administrative inconvenience. From the year 1949-50 the tax is levied on uniform rates and small companies are allowed a rebate from super tax. From the year 1966-67 the limit of income of Rs. 25,000 has been
raised to Rs. 50,000 and in place of rebate from super tax
differential rates of corporation tax have been introduced.

3. Priority Industry Allowance

Indian companies in the priority industries numbering 34
were permitted a deduction equivalent to 8% of their
earning from taxable income. These companies were allowed
the development rebate at a higher rate of 25% against the
normal rate of 15%. Under the Finance Act, 1971, the
percentage of exempted profits was reduced to 5 and the
number of priority industries was restricted to 28. The
Finance Act, 1972, has notified the abolition of this
allowance altogether.

4. Inter Corporate Investments

Until the passing Finance Act, 1965, the inter-corporate
dividends were subject to the income tax at the rate of 25%
in addition to super tax at varying rates from 10 to 25%.
The Finance Act, 1964, exempted all inter-corporate
dividends from the super tax. At present the deductions
from integrated tax in respect of inter-corporate dividend
are as under:

i] For foreign Companies

80% of dividend is received from the Indian companies
engaged in priority industries and 65% from non-
priority industries.

ii] For Domestic Companies

60% of the inter-corporate dividend received from all
companies.
5. **Expenditure on Scientific Research and Family Planning**

Revenue expenditure on scientific research is exempted in full and unabsorbed expenditure can be carried forward indefinitely. Capital expenditure on scientific research spread over 5 years and 20% of the same is allowed as deduction each year. Expenditure on the promotion of family planning among the employees is allowed in full.

6. **Export Market Development Allowance**

Indian Companies are allowed a deduction of 133.33% of the expenses incurred on the development of export markets like advertisements, market surveys and travelling outside India.

7. **Development Allowance (Section 33A)**

Under Section 33A, Development allowance at a sum equivalent to 50% of actual cost in respect of tea bushes planted on a new land or on any land previously abandoned, if planting has commenced after the 31st March, 1965; and 30% of actual cost in respect of tea bushes planted in replacement of tea bushes that have died or have become permanently useless on any land already planted, if planting commenced after the 31st March, 1965, but has been completed before 1st April, 1970. The Development allowance is available only if the assessee grows as well as manufactures tea in India - C.I.T. vs. Puthuthotam Estates (1943) Ltd. (1981).
According to Section 33A(7) actual cost of planting means the aggregate of (i) cost of preparing the land. ii] cost of seeds, cutting and nurseries, iii] cost of planting and replanting, and iv] cost of upkeep thereof for the previous year in which the land has been prepared and the three successive previous years following such previous year, reduced by that portion of the cost, if any, as has been met directly or indirectly by any other person or authority.

Where, however, the actual cost will exceed the following limits, the excess will be ignored:

<table>
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<tr>
<th>Limit Per Hectare</th>
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<tbody>
<tr>
<td>1. For tea gardens situated in plain</td>
<td>Rs. 30,000</td>
</tr>
<tr>
<td>2. For tea gardens in notified hilly areas other than Darjeeling district</td>
<td>Rs. 35,000</td>
</tr>
<tr>
<td>3. For tea gardens in Darjeeling district (one hectare = 2.471 acres)</td>
<td>Rs. 40,000</td>
</tr>
</tbody>
</table>

If the land is held under lease or other rights of occupancy the assessee will be treated as owner of such land for the purpose of the Section 33A.

It is first allowed in the assessment year relating to previous year following the previous year in which the land is prepared for planting or replanting (i.e. if expenses incurred in 1987-88. It will be allowed in the assessment year 1989-90 which previous year 1989-90, which is the previous year following 1987-88) and if there be any balance of such expenses on which such allowance is yet to
be allowed, if will again be allowed in the assessment year relating to third succeeding previous year (i.e. in the assessment year 1991-92 which has previous year 1990-91 which is the third succeeding previous year of 1987-88.

Conditions regarding creation of Development allowance reserve, utilisation of such reserve, sale or transfer of land for which such allowance was allowed, carry forward of unabsorbed Development allowance, and consequence of an infringement of the prescribed conditions are the same as in case of investment allowance.

Where an assessee is entitled to claim deductions for Depreciation and Development allowance, the sequence of allowing deductions for Depreciation and Development allowance, the sequence of allowing deductions will be as follows:

i] Current Depreciation [Section 32(1)],

ii] Unabsorbed Depreciation of earlier [Section 32(2)],

iii] Unabsorbed Development Allowance of earlier years [Section 33A(2)(ii)], and

iv] Current Development allowance [Section 33A(2)(1)].

8. Incentive to Foreign Capital and Collaboration

Important incentives provided from foreign investment are:

i] Exemption of export profits of foreign companies. If the foreign company purchases goods in India and export them, the income arising therefrom is fully exempted.
ii) A foreign company which does not distribute dividend in India is exempted from penal tax on undistributed profits.

iii) Interest and technical service fees received from the foreigners are exempted from super tax.

iv. Foreign technicians and managerial personnel enjoy 3 to 5 years tax holiday.

RURAL DEVELOPMENT ALLOWANCE (SECTION 35 CC / (Abolished from A.Y. 1989-90)

This deduction is allowed u/s 35CC for whole of expenditure incurred by a company or co-operative society itself including capital expenditure, the ownership of which is transferred by the assessee (if ownership is not transferred, the assessee will be allowed depreciation on such capital assets), for rural development in a specified area and with approval of proper authority after furnishing a certificate from a Chartered Accountant together with the Return of income, though such expenditures are not related to assessee's business.

PAYMENT TO THE ASSOCIATION AND INSTITUTION CARRYING OUT RURAL DEVELOPMENT PROGRAMME (SECTION 35CCA)

Deduction u/s 35CCA is available to all categories of assessees even where they are not directly engaged in a programme of rural development, if an assessee contributes any sum -

a. to an approved association or institution engaged in any programme of rural development/Section 35CCA(1)(a);

b. to an association or institution which undertakes training of persons for implementing any programme of rural
development/Section 35 CCA(1)(b); or

c. effective from assessment year 1983-84 to a Rural Development fund set up and notified in this behalf by the Central Government/Section 35CCA(1)(c);

on furnishing a certificate from such association etc., to the effect that it has been approved by the proper authority before 1st March, 1983, and that the training of persons for any such programme has commenced before 1st March, 1983.

Tax Structure

Corporations in India have been subjected different taxes at different rates on the basis of their class and size. Various taxes which were in force during the period under study have been discussed below:

i] Income Tax

Income tax on corporate earnings is as old as the tax on individual income. It has always been levied under the Income Tax Act and no separate statute was designed for this purpose. Corporation is one of the units of assessment. Together with income tax, corporation tax was made a permanent feature of tax system from 1886. Upto 1956-57, the flat rate of tax on corporation was always equal to the maximum marginal rate applicable to personal income. This rate was 26.25% (inclusive of surcharge of 5%). In 1957-58 the rate was raised to 31.5%. It was reduced to 21% in 196061 on account of the introduction of double taxation, and the same was raised to 25% in 1962-63. From 1965 it has been integrated with super tax.
ii] Super Tax

Super tax was levied in 1917 by a separate Act as a wartime measure on the income exceeding Rs. 50,000 at the progressive rates from 6.25 to 9.37%. In 1939 (at the time of the second world war) the exemption limit was removed and all companies were made liable to pay this tax. The basic rate of the tax was used to be prescribed every year, subject to certain rebates to smaller companies and the companies with prescribed arrangement for the declaration of dividend in India. The basic rate was 42.29% in 1956 and was raised to 50% in 1957. Inter-corporate dividends were exempted from this tax. Foreign companies paid the tax at the rate of 30% (rebate being 20%). In 1960 the prescribed rate was 55% which continued till the integration of income tax and super tax in 1965. The basic rate of integrated corporation tax was 80% in 1965. From the year 1966 onwards, the differential rates varying from 45% to 70% have been introduced for the companies of different status. This tax has been abolished since 1964.

iii] Sur Tax

Sur Tax, though a lucrative source of revenue to the Government, has been a great cause of controversy. On a number of occasions, the Government has to withdraw the levy, as it amounted to a great strain on the earnings of corporations. This tax was levied for the first time in 1918 in the name of 'Excess Profit Tax Act' for this purpose. This tax was abolished in 1947. Another tax in
the name of 'business Profit Tax' was levied at the rate of 16.67% on the profits exceeding Rs. one crore. The abatement for companies was 6% on the working capital in 1950. This tax was taken back. It was imposed in 1963 as 'Super Profit Tax' on the profits after tax exceeding 6% of the share capital but below 10% and 60% on the profits above 10%. In 1964 this tax was given up and a new tax designed as 'Sur Tax' was introduced at progressive rates. In 1965 a flat rate of 40% was levied and then it was reduced to 35% in 1966 and again to 25% in 1969. Presently, this tax is levied on the chargeable profits which exceed 10% of the capital employed or Rs.2 lakhs, whichever is greater. Chargeable profits include profits after tax plus interest paid on debentures loans.

It should be remembered that the sur tax introduced an element of progressiveness to corporation tax. But as a penal tax it has little effectiveness. Various kinds of companies have been exempted from this tax. Bhoothalingam Committee 1969 has recommended the abolition of this tax and suggested a capital levy of one percent on the entire capital of the corporations. However, the study made suggests that the capital levy proposed by the Bhoothalingam Committee is nothing but revival of wealth tax, which was in effect during 1959-60. It will raise the tax burden of all companies irrespective of profits. It does not justify the cannon of equity.
iv] Penal Tax on Undistributed Profits

This tax is levied on closely held non-priority domestic companies which do not possess the prescribed arrangement for declaration of dividend. It is imposed on the undistributed earnings whenever the dividend declared by the liable companies is less than the statutory percentage which is 90% for investment companies, 60% for trading companies and 45% for other companies. This percentage can be revised by the income tax officer in view of the current and future requirements of the business. The rate of penal tax is: 50% for investment companies, 37% for trading companies and 25% for other companies. This tax helps the Government in safeguarding revenue against the avoidance of tax caused by non-payment of dividend. This tax is not withdrawn.

v] Bonus Tax

The meaning of dividend was extended in 1939, whereby the distribution of accumulated profits - 'bonus' - was included therein. Despite the recommendation of Mathai Commission not to tax bonus issue, Government imposed Bonus Tax in 1956. It was argued that the bonus issue has a definite characteristic of income. The problem about the valuation of bonus share was solved by prescribing that the excess of market value over cost of such shares be taken as profit. Bonus tax was levied on the companies by way of reduction in the rebate from super tax at the rate of 12.50% on the face value of the bonus share, except when
these shares had been issued out of the premium received in cash. The main objective of bonus tax had been to encourage capital formation, but it caused harassment to the shareholders as well as the companies. It ceased to yield any revenue to the Government from 1964 onwards. The same was abolished in 1966.

LEVY OF MINIMUM TAX ON BOOK PROFIT OF COMPANIES
(SECTION 115(J) Withdrawn from assessment year 1991-92)

With effect from assessment year 1988-89, taxable income of any company (except those engaged in the business of generation or distribution of electricity) whose total income as computed under the provision of the Act in respect of any previous year is less than 30% of the book profit (after adjustment of all deductions for tax incentives, depreciation, brought forward losses, unabsorbed depreciation and investment allowance etc.) shall be deemed to be the amount equal to 30% of such book profits.

Book profit means the net profits as shown by the audited accounts and increased by the following items if already debited to Profit and Loss account:

a. Income-tax paid or payable and provision therefor;

b. Amount credited to any reserves, by whatever name called;

c. Amount set aside to provide for any unascertained liability;

d. Amount set aside to make provision for losses of subsidiary company;

e. Dividends paid or proposed;

f. Expenditure relatable to any income covered by Section 10 to 13A (i.e. income exempt from tax) and
g. Amount withdrawn from Reserve account u/s 80HHD that has been utilised other than as specified in Section 80HHD(4) and has not been utilised within period specified in Section 80HHD(4), if these amounts have not been credited to Profit and Loss Account (effective from 1.4.89 vide Explanation added to Section 115J(I) by the Direct Taxes (Amendment) Act, 1988).

The book profit should similarly be decreased by the following items if already credited to Profit and Loss Account:

a. Amount transferred from reserves and provisions to Profit and Loss Account provided i] the reserves have been created or provisions have been made before 1st April, 1988, or ii] the reserves have been created or provisions have been made after 1st April, 1988, and have gone to increase the book profit in any year when the provision of Section 11J were applicable;

b. Amount of income covered by Section 10 to 13A; and

c. Amount of net profit derived from the business of export or from services provided to foreign tourists by approved hotels or travel agents which are eligible for deduction u/s 80HHC or 80HHD (effective from 1.4.89 vide Explanation added to Section 151J(1) by the Amendment Act (1988).

The profits so arrived shall be further reduced by the amount of loss or depreciation which are eligible to be set off against profit of the relevant previous year as if Section 205(1)(b) of companies Act is applicable.
Apparent short-comings of book profit.

1. Depreciation may be charged in the books on straight line method, while depreciation under Income-Tax Act is allowed on written down value.

2. Provisions for sales tax, excise duty, gratuity, bonus etc. may be debited to accounts but the same is allowable as deduction on actual payment basis in subsequent year u/s 43B.

3. Profit on sale of depreciable asset may appear as credit in the Profit and Loss Account which may not ultimately be taxable in the new concept of block of assets.

4. Capital gains may appear as credit in Profit and Loss Account, which may ultimately be exempted from tax u/s 54E.

5. Gross amount of some income may be credited to Profit and Loss Account on which deductions are available under Income Tax Act.

6. Donations to political parties, charitable institutions, staff welfare fund etc., may be debited to accounts, which are not fully allowable under Income Tax Act.

7. Tax incentives based on profit u/s 80HB, 80HHC, 80I 32AB etc. are not deductible in computation of book profit.

8. In the matter of adjustment of brought forward losses and unabsorbed depreciation, it is limited to the lower of the loss or profit.

It may be mentioned here that this provision will not affect the determination of the amounts to be carried forward relating to unabsorbed depreciation, unabsorbed investment allowance,
unabsorbed losses and unabsorbed deduction to tax holiday. Since all the assessee are to follow the uniform previous year. It has been made mandatory for all companies including those companies which are following under the Companies Act any accounting year which is different from the previous year under the Income tax Act, to prepare their Profit and Loss Account for the previous year ending on 31st March for the purpose of working out book profit for Section 115J.

As per the amendment made to Section 115(1) by the Direct Taxes (Amendment) Act 1988, effective from 1.4.89 provision of Section 115J shall not apply in the case of an assessee engaged in the business of generation or distribution of electricity.

Impact of Corporation Tax
Impact means the immediate money burden of tax. In the case of corporation tax, impact is on the earnings attributable to the shareholders and the same is equal to the total yield of tax to the Government. Impact varies from company to company because of differential rates. It is not possible to study the relative impact of various taxes levied on the corporation, from the published accounts. Impact can be studied on the basis of entire tax liability with the help of tax provision : profit before tax ratio called effective rate of tax. The law prescribed high rates of tax for private and closely held companies than that for public (i.e. widely held companies) companies. In the present survey, only public companies have been included and the impact of this tax has been measured on macro basis.
Effective rates computed in respect of companies of different size and industries have been shown in table No. 2.7. Our findings are as follows:

1. Effective rate for small companies has been disproportionately higher than that for medium and large companies. It fluctuated from 30.53% (1990) to 47.35% (1986). Almost all the profits were wiped out by tax liability. The possible reason for such an anomalous situation can be the low profitability and lesser amount of concessions and reliefs availed by these companies. In the years of higher tax impact, the amount of loss and the number of loss-sustaining companies were also greater. (Table No. 2.7).

2. The effective rate of tax in respect of medium companies ranged from 28.86% (1990) to 46.39% (1985), comparatively higher than that of large companies. Here also the number of loss-sustaining companies was slightly greater than that of large companies. (Table No. 2.7).

3. Large companies were able to keep their tax liability within 32.44% (1989) to 49.10% (1985) of their profits before tax. The number of loss-sustaining companies was comparatively less than that of small and medium companies. On the whole the effective rate was lower than the basic rate. These companies availed of depreciation allowance, development rebate and other concessions on an increasing scale than that by the small and medium companies. (Table No. 2.7).
4. The rate of tax in respect of all the companies under the survey, taken together, was 31.45% (1989) to 48.50 (1985) on average below 50%. It has been influenced more by the rate of tax of the large companies and does not reflect the unsatisfactory tax burden for the small companies.

5. In all the industries the effective rate of corporation tax exceeded the overall average after 1964, due to low level of industrial activities, steep rise in losses and increasing rate of corporation tax. As a result of the above analysis we come to the conclusion that the Government should provide some relief to the small companies with total capital employed upto Rs.50 lakhs.

Incidence of Corporation Tax

Incidence of tax means the ultimate money burden. Through the process of shifting, the tax payer transfers the money burden of tax to some one else, thereby relieving him of a part or whole of the impact. Corporation tax can be shifted either forward or backward. Shifting is backward when the incidence is made to fall on factors of production including the share capital.

There are two conflicting view-points about the shifting of tax burden by the corporation in India. First, the corporation tax is shifted forward to consumers in the form of higher prices, because of insulated conditions, like increasing income and population, which enable the corporations to achieve a predetermined rate of earnings over the cost of their production. Second, the corporate sector fixes the price of goods at marginal firm price, that is to say, at a point where marginal
price is equal to the marginal cost. Consequently the burden of
tax is borne by the capital on which it is intended to fall.
Apparently, the sluggish capital market provides a partial
explanation of the burden being borne by capital.

Shifting of incidence on consumers can be measured through co­efficient of correlation of price indices and corporation tax rate indices. It can be said even without any reference to the statistical facts that both of these indices show a high rate of positive correlation in India during the period after Independence. However, the rise in the price index cannot be taken as exclusive evidence of corporation tax falling on consumers. In a scarcity economy, prices are bound to rise even without any increase in corporation tax. Regarding shifting of this tax to share-holders, it is pointed out that till the assessment year 1960-61 the income tax paid by a corporation was considered to have been paid on behalf of its shareholders. The dividends received by them were grossed up and included in their individual assessments. A deduction to the extent of tax paid by the corporation was allowed from the tax payable by the shareholders. Thus the corporations have to bear tax on the undistributed part of their profits only. But the Finance Act, 1960, removed this legal fiction of deeming the tax paid by corporation on behalf of its shareholders. Corporation has been given its lawful treatment of being an entity quite separate from its shareholders and principle of dichotomy introduced, whereby corporation is required to pay two types of taxes :
1. corporation tax on its taxable earnings and
2. dividend tax paid at source on all dividends distributed to shareholders.

Thus from 1960-61 the whole burden of corporation tax has been put on the corporation itself. But the impact of tax falls on the distributable earnings. While the incidence may fall either on shareholders through payment of lower rates of dividends and/or on corporation through reduced amount of retained earnings.

Whether the incidence of corporation tax has been borne by customers, shareholders or corporations can be studied with the help of tests, given below:

1. If it is found that the rate of return on onward fund (profit after tax/net worth ratio) and the effective rate of tax (tax provision/profit before tax) are inversely related over a given period of time, this is taken as an indicator of insignificant forward shifting of the corporation tax.

2. If the payout ratio (dividend/paid up capital) is found to be inversely related to effective rate of tax over a given time it is evident that some burden of this tax has been borne by the shareholders.

3. If the retained profits/profit after tax remains more or less constant with the change in the effective rate of tax it is presumed that the corporation tax rate does not have any significant effect on the retained earnings.

* Ved P. Gandhi, some Aspects of India's Tax Structure, Page No. 75-76.
The corporate tax rates in India, which range between 51.75 per cent and 57.50 per cent, are much higher than in other countries, especially those which compete with India in attracting foreign investment.

According to a study conducted by the Federation of Indian Chambers of Commerce and Industry (FICCI) on the corporate tax structures of 45 countries, the tax rate in India is higher than tax rate in the countries like Pakistan (30 per cent) Peru (30 Per cent), Philippines (35 per cent) Venezuela (20 to 30 per cent), Nigeria (40 per cent), Mexico (40 per cent,) Indonesia (34 per cent) and Brazil (30 per cent).

The study reveals that countries which are competing with India in attracting foreign investment have a much lower corporate tax rate as for instance, Hong Kong (16.5 per cent) Malaysia (35 per cent) Korea (20.34 per cent) and Taiwan (15 to 25 per cent).

The study says that double taxation of corporate profits is generally avoided in several countries by imputation system whereunder tax paid by companies is given credit.

In some countries the dividends paid out of the tax profits of the companies are fully exempt in the hands of the shareholder.

In India, inter-corporate dividends are exempt from tax if the dividend income received by a company is distributed by it. When the dividends are distributed to the shareholder, the dividend income together with income from UTI, interest from bank deposit etc. qualify for exemption up to a maximum limit of Rs. 7000 UNI.
It is often said that the corporate sector in India is heavily taxed. The tax burden is the highest in comparison to that in other countries of the world. It was stated in the Seminar on International Investment organised by Indian National Committee of the International Chamber of commerce and Indian Investment Centre, in March 1971, that a gross return of 30% was necessary to have a ten percent (10%) net return in India, whereas for an equal net return in U.S.A., U.K., France and West Germany a gross return of only 19%, 16%, 13% and 11% respectively was necessary.*

Every year the burden of tax on corporate Sector is increased by which impression has been created in the mind of investors and shareholders that the corporate sector is in disfavour of the Government. The excessive burden of taxation is said to be the root cause of the tax evasion.

The aforesaid notion that the incidence of the corporation tax in India is the highest appears to be a misconceived one, corporation tax would be found lower if due note is taken of the concessions and incentives allowed to the Indian and Foreign companies. Presumption that India is the highest taxed nation, is based on the comparatively higher marginal rates of tax. However, this approach is a fallacious one. The highest marginal rates of the tax do not mean increasing burden of tax. Comparison has to be based on the effective tax rates. The

Effective tax rates are different for different types of companies. Taking all concessions into account the effective rate in India is found to be in between 40 and 50% of the net earnings, and the same compares well with that in many countries of the West. The marginal rates always apply to a small minority of the assesses, who cannot avoid their tax burden. No doubt, there is a need for protecting the small companies and those belonging to the low profitability, traditional industries from the disproportionately higher tax burden. This lacuna can be removed by introducing element of progressiveness in the corporate tax structure. No one can deny the fact that in view of the low level of per capita real income of the country, corporate sector which is well established today, should not shirk its responsibility of providing revenue to the Government for achieving socialist and egalitarian society. Barring small and traditional industry companies, corporate-units of our country, have adequate capacity to pay the tax. But this does not mean that the Government should increase the tax rates recklessly, without providing basic incentives to sound and healthy growth of the corporate sector.

**Alternative Bases of Corporation Tax**

Corporation tax could be levied on gross sales, capital stock or on the earnings. A new basis 'Value-added' or national income generated has come in vogue. Tax on income has been the most commonly adopted and original base, other bases are of recent origin and are rarely used. A brief discussion of the different bases of corporation tax would not be out of place here.
Tax on Total Sales

Tax on total sales, though it has an immediate appeal is not free from drawbacks. It does not take into account the cost of production. Total sales is exceedingly, a rough way of ascertaining the tax liability and prosperity of a corporation. It has no bearing to the test of profit and fails to consider the factors which make difference between good and bad management. In its incidence it is identical with that of sales tax and will lead to shifting of burden on to the consumers and will be regressive in character. We do not favour the imposition of corporation tax and the aforesaid draw-backs of the tax on sales, specially when both these taxes i.e., sales tax as well as corporation tax are functioning well in our country.

Tax on Capital Stock

Tax on capital stock has been originated from the extension of the principle of property and wealth tax on individual to the corporation. Unlike an individual, mere possession of wealth or existence of capital does not provide any pleasure and prestige to the corporation. Without an adequate return, the capital stock does not add to the ability to pay tax. Capital of a corporation ultimately belongs to the creditors and shareholders. In fact, the income itself is the product of capital stock like fruits of trees. Tree has live value only because it bears fruit and the fruit has value. We cannot expect the company to go on paying tax indefinitely, without making any profit. Though, the capital levy is less damaging than an equivalent income tax, yet it does not discriminate between high-return risky investment and
low return-secured investment. It will be shifted to the consumers, as the corporations have no means to recover such tax from the shareholders. This tax will have to be paid irrespective of the profit. It involves a problem of valuation of assets and more so there is not agreed definition of capital.

The Bhoothalingam Committee 1969, has recommended a capital levy of one percent on all the capital owned and borrowed by the corporations, in addition to the present corporation tax and not as a substitute for it. The suggestion has been advanced on the ground of scarcity of capital. But with this suggestion, and more so in the developing economy like India, where the capital is and would continue to be the most scarce of all resources. Increasing cost of capital will itself provides a motivating factor for its right use. There is no need to impose any tax for this purpose. It will deny the financial resources to the capital intensive and price controlled industries.

**Value Added Tax**

This is a new phenomenon which is gaining ground in the continental countries, on the plea that it results into fewer misallocations of the resources than in the case of most of the other taxes. Value added tax has proved highly successful in the countries like U.K., France, Brazil, Denmark, Sweden and a few European countries. It means the tax on the total income generated by the corporate units, and distributed among the various factors of production, i.e. total value of the outputs less the cost of inputs like raw materials and depreciation. In other words, the value added in an industry consists of the gross
value produced by that industry less the total deliveries made to it by other industrial units, all measured in the domestic prices. In this process the burden of tax will be shared by all factors of production to the extent of their proportional contribution to the total cost. Its supporters argue that the value added as a basis of the corporation tax possesses advantages of simplicity and higher potentiality. It is certain in amount and easy to ascertain. This will avoid the discrimination towards equity capital existing in the present system of corporation tax.

In India, though the conditions obtaining are similar to those in the continental countries, i.e. the different States are free to collect taxes within their jurisdiction, yet the same would not be conducive to the environment required for the successful working of the value added concept in respect of corporation tax. Here, the bulk of taxes come out of "excise and customs, amounting to about 73% of the tax revenue of the Union Government. Income tax estimated at Rs. 780 crores is about 23% of total tax. Since corporation tax is only about 11% of the total tax it may be felt that there is not much scope for the application of the value added principle in India. However, excise which forms 60% of the total tax can fruitfully adopt the value added tax".* It should be remembered that the present corporation tax has got a sound and scientific base. The same is levied on the residual earnings available to the preference and

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equity shareholders. It takes the due share out of extra earnings created by debt financing. Unless the entire base of the corporation taxes is changed, there is little scope for the value added tax as a substitute for the corporation tax. So long as the sales tax is reserved for the state Governments and the excise duties levied on value of production, the full application of the value added concept in Central Taxation has to be ruled out. This tax will adversely affect the interest of labour class as the cost of production would increase and industries capacity to pay wages would decrease.

It is thus clear from the above discussion that the present system of corporation tax is in conformity with the basic objectives of our taxation policy. Those who want to substitute the present tax by the value added or capital stock tax, appear to be biased towards equity investment. Low return on equity investment is not caused by the corporation tax only, faulty capital structure, mismanagement of the business, lack of cost consciousness, low productivity of labour and other resources as well as the tax evasion, are equally responsible for the low profitability of the industrial units in India.

Wealth Tax on Companies

Sec. 40 of the Finance Act 1983 introduced wealth tax on certain assets belonging to closely held companies. The rate of tax was 2% payable every year. However, by Finance Act 1992, sec 40 of Finance Act, 1983 was abolished and now from assessment year 1993-94 an amendment has been effected in the Wealth Tax Act, 1957.
Accordingly, now all (earlier only closely held companies) companies are liable to wealth tax on certain assets owned by them. The rate of tax is 1% payable annually.

Concluding Remarks

A close look at the corporation tax structure in India, reveals that much of the time, energy and productive resources are lost in the efforts to avoid and evade the tax rather than in efficient tax-profit planning. High marginal rates of multiple taxes with many deductions and reliefs add to the complexity and encourage the tax avoidance and evasion on a large scale. Our comments on the present system of this tax are recorded below:

1. Multiplicity of Taxes

In no country of the world, one would find such a multiplicity of taxes as in India. During the period from 1950-51 to date as many as ten kinds of taxes were imposed on the corporate sector and some of them were withdrawn frequently. The taxes which constitute the corporate taxation at present are the integrated corporation tax (income tax and super tax), India’s tax, or excise profit tax on the undistributed profits of the closely held companies and capital gain tax. The taxes which have been withdrawn are bonus tax, wealth tax, super tax and expenditure tax. In the interest of simplicity, various taxes should be consolidated as one single tax and all types of incomes should be taxed on global basis, instead of scheduled basis.
2. Unstable Tax System

Frequent changes in the basis and rates of the tax amount to wide discrimination in the tax liability of the different companies. Unstable tax policy creates crisis of confidence and acts as a great obstacle to the capital formations. Long term decisions regarding investment savings, modernisation and replacement, employment and expansion are jeopardised for want of clear out and well established taxation policy of the Government. Management cannot foresee the amount of actual tax liability which would fall on the company in different circumstances. Every year the Finance Act prescribes new tax rates for the earnings of the previous year. Companies which close their annual accounts before 31st March, have to hold up their final accounts and decisions to declare dividend for want of tax considerations. Government should formulate its taxation policy well in advance, keeping in view the short and long term requirements of the economy and avoid the trial and error in the annual budgets. Every tax measure takes its time to yield results and therefore, should be planned well and given a fair trial.

3. Faulty Tax Rate

The rate structure of the corporation tax is very complicated. It is said that the companies should pay tax at flat rate. But recently there has been a departure from this principle and now the rates of tax are neither flat nor slab or step. There is a combination of all types of
rate systems. There should be one single uniform rate not exceeding 50% of the net earnings. Concessions to priority and small companies may be provided by way of allowing rebates or the entire system should be made progressive.

4. No Reward For Efficiency

"The present corporation tax being a tax on profits does not encourage cost-minimisation or maximisation of profits. It in fact, provides an umbrella to the high cost firms on the one hand and penalises the more efficient firms on the other. It is true that it restricts the expenditure on entertainments, employees' perquisites, advertisements, etc., but these expenditures even otherwise are so small a part of total cost that the impact of these on tax provision on the pre-tax profit is often negligible."*

"Corporation tax, howsoever high it may be, becomes in the long run an element of cost. In all such industries e.g. where the price of product is fixed by the Tariff Commission, prevailing rate of corporation tax is taken into account in price fixation. Increase in corporation tax induces thus a price rise and disturbs price stability."**


5. Incentives

The tax incentives to corporate investment, on the whole appear to be adequate, specially in view of the ever-increasing revenue needs of Government. However, deduction in respect of the inter corporate dividend does not act as a tax incentive. In an economy like India, where the participation of the corporations into equity is large, abolition of taxation on inter corporate dividends should be seriously considered. According to a survey by R.B.I., over 50% of the value of the corporate equity was held by joint stock companies, financial institutions and banks in 1965.* Policy of conversion of the institutional loans into equity will increase this ratio further.

Bhoothalingam Committee has recommended that the dividend tax and additional tax on undistributed profits should be abolished. Government should consider these proposals and act in this direction so as to relieve the corporate sector of these penalties.

6. Uniform Tax Year

The most important recommendation of the Bhoothalingam Committee was its suggestion that a uniform tax year be prescribed for the various types of companies. We welcome this recommendation and hope that the Government would implement the same very soon.

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* Survey of Ownership of shares in Joint Stock Companies as at the end of December, 1968.
On the whole, barring the comments recorded above, it can be concluded that the present system of the corporation tax is quite in line with India's socio-economic objectives. It is true with the requirements of a developing economy. Its successful working need an efficient administration and honest tax payers. Government should avoid frequent changes and continue the present tax system on the corporations at least for the coming ten years without resorting to trial and error practices any more. Evasion of tax resulting into black-money and concentration of economic power in a few hands have been caused by the unstable tax-policy, inefficient administration and dishonest tax payers. Those on whom the incidence of direct taxes is expected to fall do not lack capacity to pay.