Chapter X

TREATMENT OF INTERMEDIARIES
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As noted already, when income is taxed on the basis of realization, retention of profits in intermediaries like companies and cooperatives provides a convenient way of avoiding the tax. Taxation of capital gains meets the problem only partially since no tax is attracted until the gains are 'realized'. The problem is particularly intractable in the case of companies because a company is a legal entity and 'seeing through' the corporate veil is not as simple as in the case of partnerships. Yet it is generally recognized that some arrangement must be made to tax the corporate source gains to their owners. Otherwise not only equity suffers but wide opportunities are opened up for avoidance.

Taxation of companies however has important consequences for the growth and functioning of the economy and raises many complex issues. Detailed consideration of company taxation is beyond the scope of the present work. However, we propose to examine the existing provisions relating to taxation of corporate incomes from the angle of equity in order to identify the major deficiencies. Treatment of other intermediaries will also be gone into briefly.

1 Vide Chapters III & IV.
Text: Taxation of Companies in Indian Income Tax and its deficiencies

Companies have been recognized in India as taxable entities right from the inception of income tax. The Act of 1886 provided for the taxation of profits of companies at a flat rate. Shareholders were not required to pay any tax on distribution of profits already subjected to tax in the hands of the company. So long as income tax was more or less proportional this arrangement worked well and did not produce any inequity. Complications set in with the introduction of super-tax in 1917. At first, super-tax was charged on a graduated scale on the undistributed profits of companies. This provided a strong impetus for distribution and in order to counteract this tendency changes were made in the law in 1920 whereby super-tax was made leviable at a flat rate on company profits in excess of Rs. 50,000. An attempt to integrate corporate taxation with that of individuals was made in the Act of 1922 through a system whereby dividends were grossed up by the amount of tax paid by the company and credit allowed to the shareholders for the income tax (but not the super-tax) borne by the company. Operation of the 'grossing up' principle however ran into difficulty when reliefs, rebates and exemptions came to be allowed to the companies on various grounds. Grossing

2 Sec. 5 of Act II of 1886.
3 For an excellent account of these difficulties and the legislature's responses to them, see G. L. Pophale, A Quarter Century of Direct Taxation in India 1939-1964 (1965), Ch. XX.
up became particularly difficult with the introduction in 1948 of rebates for retention of profit and penalty for excessive distribution in the case of certain companies. The legislature attempted to link the formula for grossing up the dividend paid with the rate of tax at which tax is actually borne by a company in a year. But it did not work well, even though arrangement was made for grossing up only an appropriate fraction of the dividend when it was paid partly out of non-taxable income. Ascertaining this fraction in the case of each company proved administratively cumbersome. In 1959 the 'grossing up' system was abandoned and the tax on company profits was made into an absolute corporation tax. At present companies are charged to tax independently of treatment of distributed profits in the hands of shareholders at rates ranging from 45 to 70 per cent depending on whether it is a domestic or a foreign company, whether widely held or not, and several other factors like the size of the income. Besides companies,

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4 One important reason for this was that the levy of the additional tax on excess dividend which was in force for some years proved uncertain in many cases (See Pophale, op. cit., para 264).

5 Proviso to Sec. 16(2) of the Indian Income-tax Act, 1922 as amended by Finance Act, 1956.

6 The rates of income tax for companies as prescribed for the assessment year 1975 are as follows:

1. For a domestic company
   (1) if widely held, and
      (1) income does not exceed Rs.100,000 45%
      (ii) income exceeds Rs.100,000 55%

(footnote contd.)
other than those in which 'the public are substantially interested' \(\text{vide Sec.2(18) of the Income-tax Act, 1961}\) are liable to pay a penal super-tax on their 'distributable income' unless they pay out a minimum percentage of such income as dividend or unless the conditions laid down in this regard are met (vide Sections 104 to 109 of the Act). Between 1948-49 and 1967-68 companies had to pay an additional tax on dividends distributed if certain limits were exceeded. This tax took various forms from time to time. From 1964-65 it was imposed at the rate of 7.5 per cent on the whole of the dividend declared on equity capital (in the case of new companies, on dividend in excess of 10 per cent of the paid-up capital). From 1956-57 a tax was charged also on bonus shares issued by the companies but it was discontinued in 1967. Currently, apart from income tax, profits of companies exceeding \(¥2,00,000\) or 10 per cent of the capital (whichever is greater) are liable to a surtax ranging from 25 to 40 per cent.

(\text{previous footnote contd.})

(2) if closely held, and

(i) an industrial company -
   (a) on the first \(¥200,000\) 55%
   (b) on the balance 60%

(ii) Otherwise 65%

II. For a foreign company -

(i) on royalties and certain other receipts 50%
(ii) on the rest 70%

In addition there is a surcharge of five per cent on the income tax payable.
Reviewing the system of company taxation in India as prevailing in 1955-56, Kaldor had remarked:

The company tax provisions of India (perhaps even more than that of other countries) are apt to strike a detached observer as a perfect maze of unnecessary complications, the accretion of years of futile endeavour to reconcile fundamentally contradictory objectives. 7

Kaldor thought that little purpose was served by maintaining the link between personal and corporate taxation via gross-up of dividend to allow credit for the payment of income tax by the company. Company taxation, he argued, was quite ineffective as a means of taxing the gains accruing to shareholders through profit retention. The real solution, according to him, lay in taxing capital gains. Taxation of company profits should proceed independently of personal taxation. He was particularly critical of the levy of the penal super-tax on closely held companies for profit retention and the simultaneous imposition of a tax on distribution of excess dividend.

Some of the odd features of company taxation which provoked these comments have since disappeared. Separation of company and personal taxation advocated by Kaldor also came about in 1959 and capital gains were again brought under taxation from 1957-58. The dividend tax too was withdrawn in 1967 along with the tax on bonus issues. The question for consideration is, does the existing system of company and personal

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7 Kaldor, Indian Tax Reform (1956), para 155.
taxation provide a satisfactory device for taxing corporate source gains?

**Absolute Corporation Tax - the drawbacks**

So far as equity is concerned - and the main focus of the present discussion will be on equity - it is now well recognized that an absolute tax on company profits is a poor substitute for a personal tax on shareholders on the gains embodied in the profits retained by companies. For, firstly, corporation tax may be shifted forward to consumers in the form of higher prices of products or backward to labour in the form of reduced wage bill. Even if no part of company profits is passed on and is borne entirely by shareholders - a proposition which is disputed by many - the net effect of a corporation tax and an independently levied income tax on dividend in the hands of shareholders is not necessarily progressive. In fact, it can be easily demonstrated that when

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personal income tax rates are progressive and company profits are not fully distributed, levy of a non-refundable corporation tax can be regressive in that the 'extra burden' of the two taxes taken together relatively to what would be payable if there was no corporate tax and the profits were all distributed, may decline and even turn negative as one moves up the income scale, depending on the relative rates of the personal and the corporate tax and the proportion of distributed profits to the total. In USA, where this system has been in vogue since long, Holland found that in the upper income ranges the effect of the combined operation of the corporation tax and the personal income tax was certainly not more progressive than it would have been under a personal income tax with full distribution. An additional drawback of the corporation tax is that it produces distortions and leads to inefficient allocation of resources. If borne fully by shareholders it tends to discourage supply of capital for the corporate sector and if

10 Musgrave & Musgrave, Public Finance in Theory and Practice (1973), Ch. II, Sec. D. The absolute corporation tax turns into a tax shelter when \( t_p > t_c + t_p d (1-t_c) \) or

\[
\frac{t_p}{t_c} > \frac{1-d (1-t_c)}{1-t_c},
\]

where \( t_p \) is the relevant personal tax rate, \( t_c \) is the corporation tax rate and \( d \) is the percentage of after-tax profits paid out as dividend.

shifted either forward or backward it entails an excess burden. These are the considerations which led the Carter Commission to reject the levy of a corporation tax in an absolute, non-refundable form and suggest integration of personal and corporate taxation as the only real solution to the problem of avoidance posed by the use of the corporate form in business.

The scheme proposed by the Carter Commission envisaged the levy of a tax on corporate profits, but only as a withholding device. Full credit would be given to shareholders for the tax so collected from the companies when the profits were distributed. Option would be allowed to companies to allocate undistributed profits notionally among the shareholders with credit for tax realized from the company. Capital gains made on shares would be fully taxable. Companies with relatively few shareholders would be permitted to opt for 'partnership treatment'. This arrangement, the Commission felt, would eliminate the scope for avoidance through devices like 'surplus stripping' and the unneutralities inherent in the existing arrangement, improve inter-personal equity of the tax

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13 When undistributed profits were allocated notionally the cost basis of the shares for purposes of capital gain computation would be raised but would be reduced again if any distribution was made out of the allocated profits.
system and at the same time ensure that non-resident shareholders who were not liable to pay personal income tax did not escape without paying any tax on their gains from companies operating within the taxing country.

Kaldor too was of the view that to levy a non-refundable tax on companies (such as the super-tax on corporate profits levied in India until 1959) is an ineffective means of taxing the equity shareholders, for such a tax gets passed on to the consumer and, in any case, it is "a crude and undiscriminating method of apportioning the tax burden amongst the capitalists." Kaldor's prescription for tackling the problem was to switch over to expenditure as the tax base.

But if income tax was retained, he argued, the proper substitute for company taxation would be taxation of capital gains on accrual, and since accrual taxation is not feasible, full taxation of realized capital gains like ordinary income with provision for imputation of realization on bequests and inter vivos transfers. For India, however, as mentioned earlier, he recommended retention of a tax on company profits - but independently of personal income tax and at rates fixed on a consideration of such factors as the capital allowance granted to companies.

14 Kaldor, An Expenditure Tax (1955), Ch. V.
15 Kaldor, Indian Tax Reform (1956), Ch. 8.
The preceding discussion would show that viewed purely from the angle of equity the present system of company taxation in India, although it broadly follows the Kaldor scheme, is deficient in several respects. While distribution out of current or accumulated profits is treated as dividend in the hands of shareholders, when this is accompanied by release of assets, no personal income tax is levied as long as the profits are retained in the company. There is no attempt to relate the tax liability of the shareholders to the increase in their economic power resulting from the accumulation of profits in the companies. Though realized capital gains are subjected to tax, for reasons discussed earlier (Ch. III), taxation of very capital gains has not been effective so far. Absence of any provision to impute realization at the time of death and transfer by gift facilitates indefinite accumulation of such gains without any hindrance. Besides, preferential treatment of capital gains provides opportunities for avoidance even though capital gains are taxed. Of course, in the case of closely held companies retention beyond a prescribed limit invites a penal super tax (Sec. 104). But the efficacy of the tax has been seriously undermined over the years through court rulings and legislation, and it is doubtful if it exerts any

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16 Legislation has narrowed down the scope of these provisions from two directions. First, the definition of companies in which the public are substantially interested has been widened to include any company whose shares are quoted in a stock-exchange (vide Finance (footnote contd.)
influence on the level of distribution by close companies. The law governing the levy of this tax is too complicated and hedged with too many qualifications to be workable or effective.

It is evident that, the penalties for non-distribution notwithstanding, the present system of company taxation creates a bias against distribution and encourages retention. Ends of equity (and also neutrality) clearly call for larger distribution. The question is, would that conflict with growth? If so, should equity be compromised for growth?

Retention of profits by companies and growth

Whether equity is worth sacrificing for the sake of encouraging retention of profits by companies turns on the view one takes of the role of retention in the growth and functioning of the corporate sector. The question has received a good deal

(Previous footnote contd.)

Act, 1969). Secondly, by an amendment made in 1964 all Indian companies which are engaged in any industrial activity or whose investment in plant and machinery exceeds Rs. 50 lakhs were taken out of the ambit of the said provisions. The latter concession is now sought to be withdrawn by a change proposed in the Act, vide clause 27 of the Taxation Laws (Amendment) Bill 1973 as reported by the Select Committee. As explained later in this chapter it is doubtful if this change by itself can improve the efficacy of the provisions in question.

Kaldor described the provisions containing these qualifications as a peculiarly badly drafted piece of legislation. Kaldor, op. cit. (1956), p. 87, n. 37. The Act of 1961 incorporated these provisions without much change.
of attention in U.K. and other countries in recent years but there is no unanimity of opinion among economists. Kaldor has persistently argued that large retention is essential for the growth of companies and this was the main ground on which he opposed the reform of the corporation tax recently carried out in Britain to end the discrimination against distribution of company profits, which resulted from independent taxation of company and personal incomes introduced in that country in 1965. He questioned the widely-held belief that larger distribution facilitates raising more money through new issues in the capital market by pointing out that there was no evidence that funds raised externally by companies had increased significantly under a tax system that encouraged distribution. He felt that wider participation in equity capital depends on the confidence of the small investor which again depends on the protection given by the law, statutory audit etc. more than on large distribution.

18 Memorandum to the Select Committee on Corporation Tax /Report from the Select Committee on Corporation Tax, HMSO (1971), Minutes of Evidence, Appendix 15/. Kaldor's other objections to the proposed reform were that i) it would involve considerably higher marginal rate of taxation with consequent ill-effect on investment and ii) shareholders' consumption was bound to increase with the distribution of larger dividend and this would call for a higher level of taxation to maintain a given level of public expenditure.


20 For macro-economic reasons, Kaldor argued, the willingness and ability of a capital market to take up new (footnote cont'd.)
The weight of expert opinion however seems to be against providing any encouragement for retention because of the fear that it leads to inefficient use of corporate resources. Any fiscal bias in favour of corporate retention, it is argued, not only distorts the distribution of capital accumulation between the corporate sector and the rest of the economy but, within the corporate sector itself, reduction in dividends and increased reliance on retained earnings may favour investment by established firms with substantial cashflow in comparison with new and rapidly growing firms because the bias towards retention of profits induced by the tax system tends to reduce the flow of inter-firm lending through normal channels of the stock exchange

(previous footnote contd.)

issues is not dependent on the current level of distribution. He also denied that the corporation tax creates a bias in favour of debt financing by arguing that even though there might be an initial bias in favour of debts, in the long run, the relative yields of bonds and shares get adjusted [Kaldor, Report of the Select Committee on Corporation Tax (1971), op. cit.]


22 M. S. Feldstein, "Tax Incentives, Corporate Saving and Capital Accumulation", Journal of Public Economics, April 1973. It might be argued however that since dividend distribution leads to a much sharper rise in share values than retention, the wealth effect is likely to be more pronounced when dividend is paid than when not. It is difficult to say anything definitely a priori.
and money market in general. As regards the apprehension expressed by some that larger distribution might be harmful to growth as it would lead to a rise in consumption, studies by Feldstein seem to show that households see through the corporate veil and adjust their personal savings to changes in corporate profits whether distributed or not. Hence the system of corporate income taxation which induces retention may have little effect on the aggregate volume of saving. This suggests that integration of the corporation tax and the personal income tax may not have any significant adverse effect on the aggregate volume of capital formation. Efficiency considerations thus reinforce the equity case for integration.

**Role of profit retention in the growth of the corporate sector**

For several reasons, fiscal bias in favour of retention seems unnecessary and undesirable for the growth of the Indian corporate sector too. For, though the evidence is not conclusive, available studies do not show that the form of company taxation makes any appreciable difference to corporate growth. After tracing the evolution and effects of company taxation in India up to 1959 Ambirajan came to the conclusion that the impact of the corporate tax structure on investment incentives and actual investment was negligible and neutral. Patnaik's study of private corporate investment over the twenty years

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1947-67 shows that corporate investment in India expanded at an unprecedented rate over the decade starting from 1954 except for the year 1959, when restricted imports caused a setback. A slump set in after 1964 leading to a crisis in 1964-67. It appears that the impulse for growth originated at a time when company taxation proceeded on a partially integrated basis, whereas the crisis appeared after the 'classical' system, that is the system which encourages retention, was in operation for a few years. Patnaik's analysis suggests that the decisive factor behind corporate investment was demand and availability of inputs and foreign exchange even though finance may have been a limiting factor for certain periods.

Secondly, the contribution of retained earnings in the growth of corporate assets declined from 24.2 per cent during the First Plan period to 17.5 per cent during the Second Plan, 17.4 during the Third and 12.7 during the Annual Plans of 1964-69 (Table 10.1). There was an improvement in the Fourth Plan period but it is evident that the change in the system of company taxation which was made in 1959 did not improve the contribution of profit retention to asset growth till 1969-70.

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25 It may be recalled that till 1959 credit was allowed to shareholders for the income tax but not super-tax paid by the companies.

26 Patnaik, op. cit., Ch. III.
Table 10.1
Sources and Uses of Funds - Private Industrial Sector

<table>
<thead>
<tr>
<th></th>
<th>First Plan</th>
<th>Second Plan</th>
<th>Third Plan</th>
<th>Annual Plans</th>
<th>Fourth Plan (first two years)</th>
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<tbody>
<tr>
<td></td>
<td>Percentage</td>
<td>Percentage</td>
<td>Percentage</td>
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<tr>
<td>I. INTERNAL SOURCES</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Depreciation</td>
<td>30.4</td>
<td>24.5</td>
<td>30.5</td>
<td>31.7</td>
<td>35.3</td>
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<tr>
<td>2. Retained profits (including capitalized portion)</td>
<td>24.2</td>
<td>17.5</td>
<td>17.4</td>
<td>12.7</td>
<td>20.5</td>
</tr>
<tr>
<td>3. Tax provision (net)</td>
<td>3.4</td>
<td>2.7</td>
<td>1.2</td>
<td>-0.7</td>
<td>-0.1</td>
</tr>
<tr>
<td>II. EXTERNAL SOURCES</td>
<td></td>
<td></td>
<td></td>
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<td></td>
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<tr>
<td>4. Paid up capital</td>
<td>7.4</td>
<td>10.9</td>
<td>7.6</td>
<td>5.6</td>
<td>4.6</td>
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<tr>
<td>5. Borrowings</td>
<td>21.4</td>
<td>26.9</td>
<td>28.4</td>
<td>33.7</td>
<td>20.0</td>
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<tr>
<td>(i) From banks</td>
<td>6.3</td>
<td>16.4</td>
<td>18.8</td>
<td>19.1</td>
<td>13.8</td>
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<td>(i) Financial Institutions</td>
<td>-</td>
<td>0.8</td>
<td>1.0</td>
<td>4.8</td>
<td>1.7</td>
</tr>
<tr>
<td>(iii) Others</td>
<td>15.1</td>
<td>11.7</td>
<td>8.6</td>
<td>9.8</td>
<td>4.5</td>
</tr>
<tr>
<td>5. Other liabilities</td>
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<td>15.5</td>
<td>14.9</td>
<td>17.0</td>
<td>19.7</td>
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<td>TOTAL SOURCES</td>
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<td>100.0</td>
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<th></th>
<th>First Plan</th>
<th>Second Plan</th>
<th>Third Plan</th>
<th>Annual Plan</th>
<th>Fourth Plan (first two years)</th>
</tr>
</thead>
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<tr>
<td>6. Fixed assets</td>
<td>64.1</td>
<td>62.8</td>
<td>56.3</td>
<td>56.8</td>
<td>53.7</td>
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<td>7. Inventories</td>
<td>14.7</td>
<td>24.1</td>
<td>24.2</td>
<td>21.3</td>
<td>23.2</td>
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<td>8. Investments</td>
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<td>1.5</td>
<td>1.0</td>
<td>1.2</td>
</tr>
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<td>9. Receivables</td>
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<td>10.6</td>
<td>17.8</td>
<td>19.2</td>
<td>16.6</td>
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<td>10. Cash and bank balances</td>
<td>-</td>
<td>0.7</td>
<td>-</td>
<td>2.1</td>
<td>5.4</td>
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<td>11. Other assets</td>
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<td>-0.4</td>
<td>-0.1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100.0</strong></td>
<td><strong>100.0</strong></td>
<td><strong>100.0</strong></td>
<td><strong>100.0</strong></td>
<td><strong>100.0</strong></td>
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Research

It cannot be denied however that retained profits have been an important factor in the growth of companies but again there is no evidence that retention has been influenced by the form of company taxation. For the dividend payment ratio in India is remarkably stable which shows that retained profits are basically residual in character.

Moreover, it appears that internal finance is relied upon more by the large Indian companies which are usually under the control of some business house and such reliance may reflect a reluctance to go to the market for fear of losing control over the companies. Thus large retention helps the growth of giants who may not be the most efficient.

That company taxation which favours retention could produce such results is recognized even by Kaldor. Moreover, it cannot be said that the investible funds at the disposal of the companies have been put to the use that best subserves the

27 Krishnamurthy and Sastry have found that dividend decisions are largely autonomous of investment and external finance decisions and therefore retained earnings are residual in character. A. Krishnamurthy & D. U. Sastry, Dividends, External Finance and Investment (1973). This goes against the general impression that tax differentials influence dividend policy. D. T. Lakdavala, Taxation and the Plan (1956), p. 149.

28 Krishnamurthy & Sastry, op. cit., and Patnaik, op. cit.

national interest. It may be seen from Table 10.1 that while corporate assets have grown during the Plan period, proportion of the inventories in the aggregate has increased from 14.7 per cent in the First Plan period to 23.2 per cent during the Fourth. It is also doubtful, if all the fixed assets of the corporate sector which have grown steadily can be regarded as strictly productive for often one gets the impression that certain types of conspicuous luxury consumption by companies form a substantial portion of their investment in fixed assets.

Barring temporary periods of stringency, companies in India, particularly the large companies seem to be in command of more funds than they require for their productive purposes. It is the relatively small companies outside the umbrella of big business houses which have to rely more on external sources of finance. Such companies would be helped by a larger dividend pay out for, as the sharp decline in share values in India following the imposition of restriction on dividend payments in July 1974 shows, the climate of the capital market is considerably influenced by the size of the dividends paid by the companies.

To sum up, taxation does not seem to have been a major

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30 It is well-known that many large companies pre-empt bank credit but do not use their overdraft limits to the full and sometimes the unused margins exceed 50 per cent of the limit granted. So much so that the Reserve Bank was compelled to impose a 'commitment charge' some time ago.
factor in the growth of the corporate sector. There is no firm evidence to show that profit retention by companies has been influenced significantly by the form of company taxation. What is more, for several reasons the policy of encouraging retention is questionable, except as a temporary anti-inflationary device. Hence both equity and efficiency considerations call for encouraging larger distribution for which integration of personal and corporate taxes is more appropriate than an absolute corporation tax on companies.

But however persuasive the case for integration may be, as the Canadian experience shows, it would be unrealistic to think that full integration will find acceptance anywhere. The corporation tax has proved such a rich source of revenue that no government is likely to forego it altogether. Apart from causing revenue loss full integration is likely to raise administrative costs and also blunt the edge of incentives like capital allowance. Opposition to integration is likely to come not only

31 This of course would not hold good for close companies who are required to pay a penal super-tax for excessive retention. But as stated earlier, these provisions are applicable only in a few cases.

Evidence on the relationship between pay out ratios and the level of personal tax rates in USA is conflicting. While Britain found the two to be inversely related, Wilson did not find any significant relationship between them. J. A. Brittain and Thomas Wilson quoted in G. F. Break, "Integration of the Corporate and Personal Income Taxes", NTJ, March 1969.

32 Break (1969), op. cit.
from governments but also from business interests even though they complain of double taxation when there is an absolute corporation tax. Besides, the economic system is now adjusted to the corporate tax, either through shifting or through discounting via changes in share values. To the extent the tax has been shifted forward, abolition of the corporate tax will merely provide a subsidy for the existing shareholders, unless reverse shifting takes place, as Musgrave pointed out while reviewing the Carter Commission's integration proposals. Complete reverse shifting seems unlikely.

An alternative base for taxation of companies

A case for an absolute corporation tax can of course be made out even though it fails to stand on equity grounds. The considerations on which a company can be required to pay tax as a separate unit should be looked for in the benefits they receive rather than in arguments sometimes advanced such as that they are

33 This is what took place in Canada, somewhat surprisingly (See M. Buccovetsky & R. M. Bird, "Tax Reform in Canada; A Progress Report", NTI, March 1972).


35 The objection to the corporate tax in equity, it may be stressed again, is not that it involves double taxation but that it is either passed on or provides a tax shelter for high income taxpayers while taxing the small shareholders regressively.
a legally separate entity distinct from the shareholders etc. An even better ground for an absolute corporation tax can perhaps be derived from the proposition that it furnishes a useful instrument of control. For purposes of control and also from benefit considerations, however, net profits seem to be quite unsuited as the tax base. The incentive for inefficiency and wasteful expenditure which the present system of taxation of profits provides has led some to think that a factor tax i.e. a tax on the value of factors used would be preferable to the tax on profits. A shift from profits to expenditure as the base for company taxation would seem to be desirable in the Indian context too.

But so long as income remains the principal base for personal taxation it will be necessary to make sure that corporate source gains are taken into account in some way.

36 This was the ground on which the TEC sought to justify the corporation tax. See for a discussion of the pros and cons of an absolute corporation tax, D. T. Lakdawala, op. cit., pp. 142-45.


Several solutions are suggested for this purpose. One is to treat companies as partnerships and this is considered eminently fair by many. Its application however seems impracticable in the case of large corporations with their complex capital structures, large number of shareholders and frequent changes in ownership, though the Musgraves do not consider this objection very convincing. Recognition of income on annual revaluation of shares - which is another alternative - is also impracticable particularly for close companies. Proposals for income recognition on periodical revaluation of quoted shares did not find acceptance in Canada. Since full integration also is unlikely to gain acceptance because of the risk to revenue, the only practicable solution seems to lie in a via-media such as partial integration.

**Partial Integration plans**

There are several ways of achieving a partial integration viz., (i) permitting a credit for a fraction of the dividend received by shareholders against their income tax,


42 This proposal was put forward in the White Paper brought out by the Canadian Government in the wake of the Carter Commission Report (Bucovetsky & Bird, *op. cit.*). A suggestion by the Twentieth Century Fund too ran on similar lines. But even Simons who was an advocate of integration did not think it to be practicable (See Ch. III).
(ii) exclusion of a portion of the dividend received by shareholders from their taxable income, (iii) levy of a tax on retained profits, and (iv) allowing a credit to shareholders for part of the tax paid by the corporation on its profits. In essence all these methods seek to impose an additional tax burden on retained profits. Most of them however seem to suffer from one defect or the other. The dividend received credit gives uniform credit to all taxpayers irrespective of their income and is thus inequitable. Tried for some years this method was abandoned in USA in 1963. The dividend exclusion which is now in vogue in USA, and also in India (with an upper limit), moderates over-taxation to some extent but makes undertaxation more pronounced.

The simplest method is to levy a tax on undistributed profits. While suggesting this method uniformly for all companies, public and private, the Australian study Group on tax reform proposed that bonus issues should be treated as distribution and accordingly included in the shareholders' income. They wanted the tax on undistributed profits to be levied at the maximum marginal rate of personal income. This system would enable the companies to retain the funds they require. The shareholders too would not be put to any undue hardship as the companies would be required to deduct tax at source from all

Holland, The Income Tax Burden on Stockholders (1958). See also Peckman, op. cit. (Ch. 5) for a discussion of the alternative methods.
distributions. The Australian Study Group's scheme which was similar to that of the Carter Commission appears to be the simplest method of tackling undistributed company profits.

Another way of achieving partial integration is to allow credit to shareholders for part of the tax paid by the corporations as is being done in Britain since 1971-72. The British method however does not remove the scope for base erosion entirely since it does not contemplate taxing the undistributed profits at the maximum rate of personal income tax. Hence under the British system the responsibility for preventing erosion would lie heavily on the capital gains tax.

If the British method is followed, to make the capital gains tax effective it would be necessary (i) to provide for constructive realization on death and inter vivos transfer and (ii) formulate a more rigorous method of valuation of shares than is followed in India at present for purposes of various direct taxes like wealth tax and estate duty. For a proper share valuation, it would be useful to classify the companies into two


45 For a discussion of the alternative methods of giving this credit, see Report: from the Select Committee on Corporation Tax (op. cit.) The choice of the Select Committee was confined mainly to two methods - the two-rate method and the imputation method of the French variety. On a consideration of the international implications, the Select Committee recommended the adoption of the imputation method although the Green Paper (Cmd. 4630) issued by the favoured the two-rate system.
groups, viz. (a) those whose shares are quoted on a recognized stock exchange and (b) others. Shares of unquoted companies would of course have to be valued on the break-up basis. As for quoted ones it is well known that market quotations seldom reflect their real value.

Of course, small shareholders who have no role in shaping the affairs of the company have very little access to the intrinsic worth of the shares. But this is not true of those belonging to the controlling group. While proposing a new approach to company taxation by removing the tax on company profits Turvey suggested dividing the shareholders into two groups, viz. those who own but do not control, and those who both own and control. In his scheme there would be no tax on companies; shareholders who own shares but do not control the company would be taxed on the accrued gains on the shares as measured by the annual increments in the share values as per stock exchange quotations while those who both own and control would be required to take their aliquot share of undistributed profits as income. This principle may be adopted in the assessment of capital gains from shares on constructive realization.

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46 c.f.... "stock exchange quotations do not offer the simblence of a guide to a valuation of shares for investment purposes which is their real value". R. L. Sidey, The Valuation of Shares (1950).

47 Ralph Turvey, "A Tax System without Company Taxation", Lloyds Bank Review, 1963. It would be more rational to go by this principle also in the valuation of shares for wealth tax and estate duty.
(viz. on death and gifts). In the scheme proposed here the controlling group in the quoted companies also will be taxed on the gain ascertained on the basis of the net worth of the company.

Penal super tax for close companies - Case for abolition

We may now summarise and briefly note the main points of difference between the approach suggested here and the existing system of taxing corporate source gains. The scheme proposed here envisages the levy of an absolute tax on companies preferably with non-wage expenditure as the base and a tax on undistributed profits of all companies at the maximum marginal rate applicable to personal incomes. If profit retention is to be favoured - though the case for it is not as clear as is usually thought - then the tax on undistributed profits may be dispensed with but the provisions relating to taxation of capital gain from shares have to be tightened and redesigned. Realization should be imputed on bequests and transfers and the value of shares on such imputation should be computed in the case of nonquoted shares on the basis of their break-up value while in the case of quoted shares the stock exchange value will be relied upon only for shareholders falling outside the controlling group at the relevant time. For those within the controlling group valuation will be based on net worth.

For several reasons the above scheme would appear to be superior to the existing method of tackling the undistributed
profits of companies. At present there is no tax on undistributed profits of widely-held companies. Capital gain on the shares of such companies is of course liable to be taxed on realization. But as noted already, this means postponement, which, in the absence of constructive realization on death or transfer, can be indefinite. Closely held companies are no doubt penalized if they retain profits after tax beyond a prescribed level. But the provisions are somewhat anomalous as well as unworkable and ineffective. They are anomalous because if retention is generally considered desirable it is somewhat inconsistent to levy a penal tax on retention. Secondly, the distinction between closely held and widely held companies on which the liability to penal tax turns does not make much sense because, as is well known, many of the public companies (which are mostly regarded as widely held) are public only in name; in reality, they are no different from private ones. In fact, few of the companies through which business houses retain their control over industry come under the category of 'private' as defined in the Companies Act. Of course, not all public companies are regarded as widely held. For being treated as widely held it is not enough that a company is not a private one; it must also satisfy a few other conditions such as that it is controlled by not less than six persons throughout the year. The application of these tests is notoriously difficult.

See Sec. 2(18) of the Act.
and has given rise to numerous litigations. Not only Kaldor but almost every expert body on taxation since Kaldor has commented on their complexity and futility. The task has of course been simplified considerably since 1970 by changing the law to provide that a company whose shares are quoted in a recognized stock exchange will be regarded *ipso facto* as widely held. But in the process the provision has lost its edge. Another factor obstructing the wider application of this provision is the stipulation that it cannot be invoked if it is shown that a larger distribution would be unreasonable. Its operation thus turns largely on a subjective judgement about the reasonableness or otherwise of a distribution and whenever any question arises about reasonableness it is the businessman's point of view which usually prevails. As Boothalingam remarked, "in a large measure these measures are inoperative." It is doubtful if the attempt now being made to revive these provisions would succeed for the basic difficulties will remain. In USA also the tax leviable on accumulated earnings of corporations has not been effective in forcing large distributions primarily

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49 See for example, the *Report of the Working Group on Central Direct Taxes Administration* (1968), paras 5.8 to 5.10; S. Boothalingam, *Final Report* (1968), paras 5.28 to 5.29 and *Direct Taxes Enquiry Committee, Final Report* (1971), para 5.84.


51 Boothalingam, *op. cit.*, para 5.29.

52 *Taxation Lands (Amendment) Bill 1973* as reported by the Select Committee, clause 28, since passed.
because the law permits retention for the "reasonable needs of the business" and wide latitude is allowed by the courts to businessmen in the determination of reasonableness. The only effective way to prevent base erosion from corporate retention is to levy a tax on undistributed profits without any discrimination and without leaving any discretion regarding reasonableness etc.

In sum, the best method of preventing base erosion of individual income tax through retention of profits in companies is to go in for full integration of the tax on company profits and personal tax. If however a corporation tax is considered indispensable it should be levied on company expenditures instead of on profits. Undistributed profits should be subjected to tax at a fairly high rate without any discrimination; should be regarded as distribution. Alternatively partial integration can be achieved by allowing credits to shareholders for a part of the tax paid by the companies. In any case, for tackling erosion from corporate retention, assessment of capital gains from company shares should be made more rigorous.

53 Sommerfeld et al., *An Introduction to Taxation* (1972), pp. 88-89.

54 cf. "The point is that Revenue Officials should not in fairness be entrusted with such wide discretionary powers", - Kaldor (1956), op. cit., para 158. History of the provision shows that the only time when it worked well was when the discretion of the authorities in applying was limited (See Pophale, op. cit., Ch. XXI).
Partnership Firms and Associations
of Persons

Intermediaries like firms present much less of a problem than companies. Profits of such intermediaries can be easily allocated to the partners and taxed in their hands. Trouble arises because such treatment gives scope for income splitting by setting up spurious firms with relatives and nominees as partners. To meet this problem Indian income tax permits the income of partnerships to be allocated and taxed in the hands of partners only in the case of firms which follow a certain discipline as laid down in the Income-tax Act (Sec. 184). These firms are called 'Registered Firms' (RF). Unregistered Firms (URF) are required to pay tax on their income at the same rates as applicable to individuals. Share of income of a URF is aggregated in the total income of partners for rate purposes.

The discipline implied in registration however has not succeeded in preventing avoidance and evasion through the creation of bogus partnerships. The rigour of the conditions for securing registration was considerably watered down by successive court rulings as a result of which registration could be obtained even by a firm in which some of the partners were found to be nominees of others. As a remedy for this a tax is now levied on the income of registered firms in addition to that levied on the partners in respect of their share in the firm's profit.

This tax has been in force since 1956 and now it is levied on a graduated scale ranging from 5 to 24 per cent (in the case of professional firms, 4 per cent to 22 per cent). Bhoothalingam and many others have strongly criticized the levy of the tax on registered firms as grossly unfair.

Taxation of the same income, once in the hands of the registered firm and of the shares again in the hands of the partners, clearly offends equity. If the intention is to subject all firms to a penalty because partners of some firms are sometimes found to be dummies of others, then the system is very iniquitous to genuine firms. The proper remedy for spurious splitting of income through the medium of sham partnerships is to trace the identity of the partners and prescribe severe penalties for those who use others as their dummies for entering into such contracts. Where the partners' identity cannot be satisfactorily established, it is now laid down that the firm will be liable to be treated as a URF. This however does not quite meet the problem. For there may often be situations where it still pays to split incomes by setting up a number of URFs, each assessed as a separate unit. There is a provision in the law authorizing the tax authorities to treat a URF as RF and allocate the income among the partners when it is beneficial to revenue.

56 Bhoothalingam, op. cit., para 7.5.
57 Taxation Laws (Amendment) Act 1975, Section 51.
58 Sec. 183(b).
But the provision is of no help when the identity of the real partners remains unknown. Besides, for ascertaining whether this course is beneficial to revenue one requires information about the identity of the real partners and their individual income, which is not always easy to obtain.

To check avoidance through this device effectively a better course is to levy tax at the maximum rate appropriate for individuals on the income of all firms whose partners' identity is not fully established. In all other cases the income of the firm should be allocated among the partners, provided the particulars of partners' name and their respective shares are furnished within, say, three months of commencement of business. Similar provisions should apply to associations of persons as well. At present tax is leviable at a flat rate (of 65 per cent) in the case of trusts whose beneficiaries are indeterminate. There is no reason why URFs should be treated differently.

Treatment of Mutual Organizations

Mutual organizations are those formed by members joining together in order to carry on an activity (say for buying or selling) and acting as a 'residual claimant' against the surplus of the organization or simply as supplier or consumer. In a broad sense these include cooperatives, credit unions, mutual benefit funds, chit funds as well as chambers of commerce, members' clubs and fraternal orders.
Taxation of gains derived through these organizations presents problems because, firstly, the gain seldom emerges in a measurable form, being appropriated through reduced prices of goods and services and so on. Secondly, under the general law, the surplus accruing to a mutual concern cannot be regarded as income by virtue of the principle that no man can make a profit out of himself. The important condition required to be satisfied for being treated as 'mutual' is that there should be complete identity between contributors and participants.

There are however some special provisions in the Income-tax Act which have the effect of overriding the general principles stated above to a limited extent. One of them is designed to ensure that any surplus accruing to a mutual insurance concern is brought under the tax. Next, under Sec. 28(iii) of the Act, income derived by a trade, professional or similar association from specific services performed for its members is taxable as business profit, no matter whether the association is 'mutual' in character or not. So far as cooperatives are concerned, tax liability depends upon whether it is a mutual concern earning taxable profit. Certain incomes of cooperative societies are however partially or fully exempt under specific provisions of the Act.

60 Sec. 28 (iii) of the Income-tax Act, 1961 read with Sec. 2(24)(v).
61 Kanga & Palkhivala, op. cit., p. 85.
From the angle of equity it is clear that the tax base should include all gains of the taxpayer including those resulting from his association with a mutual concern. Practical difficulties - mainly of valuation - however stand in the way of adopting such a straightforward course.

**Alternative courses**

Consistent with their approach, Carter Commission recommended two alternative courses for the tax treatment of mutual organizations. The first is to subject to tax in the hands of individuals all dividend or similar distributions by such organizations while allowing the organizations to deduct such payments from their income provided more than 50 per cent of dividend so distributed is in the form of cash. Organizations themselves would be taxed at the corporate rate on their unallocated income. Dealings with non-members would be treated as separate business from dealings with members. Losses originating from the provision of consumer goods and services to members are not to be set off against any other income of the organization. Considering the problem involved in preventing such organizations from using their income from unrelated business the Commission suggested, as an alternative, inclusion of imputed income derived through these organizations. Such imputation would require to be made only on assets employed in the primary function of the organization such as buildings, furniture and
fixtures and inventory. These recommendations were meant to apply broadly to cooperatives also. In other words, in this scheme their income would be taxed at the corporate rate but dividend distributed mainly in cash allowed to be deducted from the organization's income. Tax would be deducted at 15 per cent from such distribution.

The Carter Commission's proposals for taxing all unallocated surplus of mutual organizations at the corporate rate provide a rational way of treating the gains arising from mutual activity. The problem however is that most of the activities of such organizations partake of the character of services. There seems to be no practicable way of dealing with this practice except restricting the loss from dealing with members to be set off only against the surpluses generated from the same activity. Imputation of income from assets may not be worthwhile in most cases. There should however be uniform treatment of all mutual organizations whether or not there is complete identity of the contributors and the recipients of funds so that disputes which often arise over the nature of the organization are avoided.

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64 In one recent case the question was whether a mutual benefit society was 'mutual'. It had to go up to the Supreme Court for a decision C I T v. Kumbakonam Mutual Benefit Fund Ltd. (1964) 53 ITR 241 (S.C.). The Supreme Court said 'no', reversing the decision of the High Court.
The more important question which arises for consideration in this connection is the treatment of cooperatives. Originally, the Act of 1922 provided no exemption for cooperatives. They were of course eligible to be treated ordinarily as 'mutual' organization where their activity so warranted. Cooperatives in India have however enjoyed exemption even when their activity was not wholly mutual. By a notification issued in 1925 (as amended from time to time) the profits of any cooperative society other than a few specified ones were declared exempt. In 1960 the Supreme Court decided in a case that the exemption contemplated in the notification of 1925 applied to profits of cooperative societies not merely from business with members but to profits of any business. Since 1960 the pattern of this exemption has been changed. At present income of all cooperative societies is exempt up to Rs.20,000 and business income of coops engaged in specified activities (agriculture, banking, rural credit, milk production and cottage industries) is completely exempt. Income of labour coops and societies engaged in fishing and allied activities is also exempt provided certain conditions are satisfied. Income of cooperatives not covered by exemptions is taxed at a rate of

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40 per cent (plus surcharge of 10 per cent). Until recently (1973), dividend distributed by co-ops was also exempt from tax. Role of cooperatives in helping weaker sections is widely acknowledged. Preferential tax treatment of coops however is justified if the benefit goes only to genuine institutions. There is a widespread feeling that the cooperatives have not been helping those whom they were meant to serve. Hence the Wancoo Committee suggested that cooperatives should be subjected to company rates of tax on their assessable income.

Corporate treatment in the case of cooperatives in the matter of taxation may not be fair to genuine cooperatives and would not be acceptable. However, some reform seems needed. Now that dividend distributed by the cooperatives is taxed, a tax may be charged on the undistributed surpluses of the societies and credit for the tax so realized given to members when distributed. No tax need be deducted at source for distribution up to a specified amount (say Rs.2,000). Allocation of shares etc. should however be treated as distribution. Losses of consumer co-ops should be set off only against the profits of the same activities as in the case of any other mutual organization.

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67 Even agricultural credit societies, it has been found have served to benefit the cultivator households in the higher 'asset group' ... more than those in the smaller group [Report of the All India Rural Credit Review Committee (1969), pp. 126-28.]

68 Direct Taxes Enquiry Committee, op. cit., para 5.46.
Trusts

Trusts are created by transfer of assets to a person or group of persons who hold the assets for the benefit of specified individuals or groups or for the public in general. As the Carter Commission remarked, "The Trust is a very flexible legal instrument that can be adapted to a variety of purposes." That is why it is more difficult to tackle than partnerships and such other intermediaries.

So far as private trusts are concerned (that is those not meant for the benefit of the public) the Indian Income-tax law takes the position that the income of such trusts shall be taxed either in the hands of the trustee or directly on the person on whose behalf or for whose benefit the income in question is receivable. When the shares are indeterminate (as in a discretionary trust) or the beneficiaries are unknown the tax is now charged at a flat rate of 65 per cent. Till 1970, income of such trusts was taxable at the rate applicable to that associations of persons. It was however found this provided scope for reducing the tax liability by setting up a number of trusts each one of which derives a comparatively small income, especially when some of the beneficiaries have large personal incomes. To minimise the scope for avoidance through this

69 Report of Royal Commission on Taxation (1966), vol. 4, p. 149.
70 Sec. 161 of the Income-tax Act, 1961 read with Sec. 166.
71 Sec. 164.
practice the provision for applying a flat rate of 65 per cent was introduced.

Scope for avoiding income tax by setting up trusts is however not yet fully removed. For the rate of 65 per cent is still below the maximum rate applicable to individuals and HUFs (which is now 77 per cent). It is possible to escape the 65 per cent rate by conveying properties to a deity and setting up a private religious endowment; for the income of such trusts or endowments is assessable as that of as a separate tax unit, either in the status of an artificial juridical person or as an individual if the Shebait or manager is treated as a representative assessee. Besides, incomes of charitable trusts which are found ineligible for exemption are assessable as that of an association of person.

The scope for avoidance could be minimised and the law simplified considerably if the incomes of private religious trusts were made taxable at the maximum rate applicable to

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73 For the idol is treated as an 'artificial juridical person' as contemplated in Sec. 2(31) of the Income-tax Act, 1961.

74 Holding property as a Shebait also has the additional advantage that no estate duty is leviable on the death of the Shebait since the office of the Shebait, though considered 'property' for purposes of inheritance and even in the context of rights guaranteed under the Constitution, is a fiduciary office for purpose of estate duty (Manchar v. Bhupendra, AIR 1937 Cal. 791; Ganesh v. Lal Babary AIR 1936 PC 318; Commissioner of Hindu Religious Endowments, Madras V. L. T. Swamiar, AIR 1954 S.C. 288).

75 By virtue of Sec. 164(2) of the Act.
individuals or, at the option of the Shebait or manager, as the income of their respective families when the family is adopted as the basic unit or, otherwise, as the income of the individual Shebait or manager. The position would be very much simpler if the non-exempt income of charitable trusts also was taxed at the maximum rate, which is not the case at present.

Charitable trusts

Trusts (or endowments) created for charity give rise to problems of a different kind because income from property held for charitable and religious purposes is exempt from tax. Charities have been accorded exemption from income right from 1886. The exemption granted under the Act of 1886 however ran in simple terms and applied to any income from property solely employed for religious or public charitable purposes. What constitutes 'charity' was however not indicated. A definition of 'charitable purpose' was inserted in the Indian Income-tax Act of 1918. Following Lord McNaghten's famous enunciation, 'charitable purpose' was defined as "relief of the poor, education, medical relief and any other object of general public utility." Exemption granted to charitable institutions has given rise to widespread abuse. The factors mainly responsible for this are: 1) property has been taken to include 'business' and 2) accumulation of trust funds without actual application to charity has also been regarded as charitable use. Businessmen found it convenient to exercise control over their concerns
through the medium of charitable trusts as it enabled them to accumulate profits without incurring any liability to pay income tax.

In order that the tax exemption which confers such competitive advantage is not misused, an amendment to the law made in 1953 stipulated that business income of a charitable body would be exempt only if the business activities are themselves the primary purpose of the charity (e.g. the production and sale of handicrafts by an institution entrusted with the task of imparting vocational training to displaced persons) or the work was carried on mainly by the beneficiaries. Distinguishing business activities which formed the primary purpose of the trust from those which are not has however proved difficult. 'Charitable purpose' being wide enough to include any activity of general public utility, such activities as newspaper publication and that of commerce chambers came within the definition of charity. The 1961 Act qualified the words 'any other object of general public utility' with the requirement that it should not involve the carrying on of any activity for profit.

The practice of funneling undisclosed earnings through charitable trusts nevertheless continued. Trust funds were invested largely in the business of the founders or donors. In its 121st Report (1970) the Public Accounts Committee observed, with

reference to 45 trusts connected with business houses and having a corpus of Rs. 24.11 crores, that investments of 32 (out of the said 45) in industrial concerns of the associated group exceeded 50 per cent of the total funds of these Trusts and in some cases exceeded even 90 per cent.

A series of changes have been made in the law after the 1961 Act came into operation the main thrust of which has been to deny exemption to trusts which accumulate income beyond a specified limit (unless the accumulation takes the form of investment in government securities or the like) and which enure for the benefit of the founders of the trust, or their relatives or concerns with which they are connected. Investment of funds in such concerns was also ordinarily regarded as a benefit (unless made in the form of debentures etc. for which adequate interest is paid). These changes along with a denial of exemption in respect of accumulated income of charitable trusts were brought about through the Finance Act of 1970. These were however considered inadequate in some respects and harsh in others. Following the recommendations of the Wanchoo Committee it was proposed to make further changes in the law, the major effects of which would be as follows: 1) accumulation of receipts (including voluntary donations) of such institutions would be permitted up to 25 per cent; 2) any donation of which the source cannot be identified would be treated as non-exempt income of the trust and taxed at the rate of sixty-five per cent; and
3) investment of funds in any business concern not owned or controlled by the Government would entail denial of exemption. There would be a ban on any business activity by such trusts (that is, if they wanted exemption from tax) unless the activity happened to form a primary purpose of the trust.

Tax exempt status of religious and charitable funds has come in for good deal of public attention in USA too in recent years and this has led to curtailment of their tax privileges. In 1950 unrelated business income (in excess of $1,000) of such organizations was made liable to pay tax at regular corporation tax rates. The Tax Reform Act of 1969 put further curbs on their tax privileges. Private foundations are now required to pay tax on investment income. Special taxes apply to unrelated business income, and certain types of transactions entered into by these foundations (e.g. those aiming to exercise political influence, provide working capital for donor corporations and other objectives not compatible with charitable status).

Considering the widespread misuse of the tax privileges of charitable organizations some restrictions or imposition of rigorous conditions for qualifying for exemption are unavoidable particularly in a country like India where a charitable trust can be formed with extraordinary ease. The proposal to withdraw

77 Clauses 5 and 6 of the Taxation Laws (Amendment) Bill 1973, as originally introduced in Parliament.

78 Sommerfeld et al, pp. 502-3.

79 No written deed is necessary; only a declaration of intention to dedicate property to charity is enough. See B. K. Mukherjea, Hindu Law of Religious and Charitable Trusts (1952).
exemption for trusts investing their funds in unrelated business (except in government concerns) was therefore not unreasonable. The recent proposals however are marked by certain anomalies and many of them have been watered down by the Select Committee. The crucial question is whether the activities of charitable organizations are such as to merit concessional treatment. It would be dogmatic to assert that all such organizations are phoney though a good many of them probably are. The main task is to keep out underserving organizations from the benefit of exemption without denying the benefit to the deserving ones. For that, more direct policing is needed and remedies available against mismanagement of charitable institutions such as the Civil Procedure Code should be applied. But once an organization is considered worthy of support, restrictions such as charging tax on anonymous donations seem incongruous and illogical. The Select Committee's action in dropping this proposal is therefore justified. But, to permit investments made before June 1973 in organizations related to donors to continue without any consequence on the exempt status of the trusts as is proposed by the Select Committee/restrict the scope of the new provisions considerably. Otherwise the recent proposals seem to provide a workable scheme of operating the exemption for charities. However

80 Taxation Laws (Amendment) Bill, 1973 as reported by the Select Committee on March 20, 1975.

81 Vide para 16 of the Select Committee Report.
it remains to be seen how far they succeed in checking the abuse of the tax privileges.

In short, the basic approach should be to allocate the income of intermediaries to their recipients or beneficiaries to the extent possible. Exceptions should be made only where the beneficiaries cannot be identified and in such cases the maximum tax should be realized. Every care must be taken to see that charitable institutions are not used as a vehicle for tax avoidance.