CHAPTER 1

INTRODUCTORY
Introduction

Taxation is a major instrument of social and economic Policy. Today, taxation is attracting wider attention and more careful study than it did in the past. In search for more revenues, the corporate sector has received full attention from the state in view of its growth in size and profitability. The corporate undertakings have afforded a convenient basis for special tax treatment. The amount of corporate tax, i.e., the income tax paid by the companies, is a significant contribution from the corporate sector to the Indian exchequer. The Rates of Income Tax on companies, both private and public, are very high and constitute a major portion of total spending of a company.

The role which finance plays in the overall making of a firm is undoubtedly crucial, but the critical part, which the tax plays in the financing function of an enterprise, is of no less significance. The Tax Reforms Committee chaired by Prof. Raja J. Chelliah in its final report recommends the retention of the existing "classical system" of taxation for the present with the lowering of the corporate tax for all domestic companies.

A careful study of the taxes influencing business decisions and financial policies is of great importance in view of the increasing burden of taxation places upon corporate sector. The effect of taxation on the corporate financial policy is reflected in its capitalisation. The present study entitled "CORPORATE TAX
STRUCTURE AND PLANNING; A CASE STUDY OF EASTERN INDIA" has been undertaken to examine the impact of tax on corporate capital structure-financing of the selected private sector corporate entities in the eastern India during the period of 1980-81 to 1995-96.

SCOPE OF THE STUDY

The present study has been coached into two parts. The first part pertains to the theoretical literature relating to the industrial and corporate growth in India, corporate taxation, corporate tax planning and financing of capital structure and structure of corporate taxation in India. This part also explains elaborately the impact of tax concessions on the financial policies of the corporate enterprise, corporate tax burden and capital structure decisions. The second part deals with the preliminary analysis of data based on level of equity share capital in the total capital structure of the sample companies. It would further highlight the bearing of the amount of corporate tax upon the equity capital composition plus outside finances. It also highlights the outcome of the quantitative analysis of the data.

OBJECTIVES OF THE STUDY:

Corporation tax as one of the direct taxes has been a major source of government revenue in advanced countries. In the case of developing countries, for
example, "the primary problem is by one means or another to create the atmosphere in which corporation tax can become an important element in the national revenue." Of late, however, developing counties including India, have attaching great importance to corporate public revenue. Corporation tax, as an important ingredient of the fiscal system has a three fold role to play: to transfer resources from the private to public sector; to bring about equality in income and wealth distribution; and to promote economic growth, stability and efficiency.

The objectives of the present study is (i) to examine the impact of tax on financing of capital structure of the sample companies; (ii) to highlight how far the financial decisions; total volume of gross investment, dividend policy, composition of financing, are influenced by the tax considerations. (iii) to analyse the capital structure decisions basing on tax considerations; (iv) to offer workable suggestions.

NATURE OF THE DATA REQUIRED:

The nature of the data required for the purpose is composed of the following:

(1) Information relating to growth of Joint Stock Companies in India in terms of companies and capital employed.

(2) Annually published financial statements of sample companies during 1980-81 to 1995-96.
(3) Corporate savings defined here in after in India.

SOURCES OF DATA:

The data used in our study are mostly from the secondary sources. Information relating to growth and development of corporate entities, corporate savings etc. at the national level have been obtained from various books, periodicals and Government reports. Information relating to sample companies has been obtained from the various issues of stock exchange directories, Bombay. The data are spread over a period of 16 years—from 1981 to 1996—a period moderately sufficient to analyse the performance of companies.

Selection of the Sample:

Keeping in view, the scope of the study, it is decided to choose companies on the basis of purposive sampling, rather than taking the whole universe. To maintain uniformity of the sample all statutory corporations, Government Companies, private limited companies have been excluded. Further it has been decided to include in the sample such public limited companies which are registered, working in the state of Assam, Bihar, Orissa and West Bengal during 1980-81 to 1995-96 and have listed themselves in any of the stock exchange in India. Further, the study includes only non-financial companies either registered or working in the above mentioned states of the Eastern region. Further we had to
choose those companies whose completed data could either be procured from stock exchange office directory or from registrar of Joint-stock companies for the entire period of study. Companies liquidated during the period of study are excluded from the sample. Continuity and homogeneity in the available data is a prerequisite for studying the long-term trend to analyse the performance of the corporate sector.

Techniques of Analysis:

The data collected from the financial statements of these companies are analysed with the help of different accounting and statistical techniques and tests. Correlation technique has been used to identify the extent of relationship and the movement of equity capital with corporation tax, equity earnings, and accelerator variable representing the growth in the net fixed assets of the corporate entities. The analysis of retained profit as a source of internal fund is aimed at establishing relationship between internal sources and some of their uses. In the process we have correlate internal sources and its components with fixed assets. The accumulation of internal funds has been influenced by several factors. The impact of each factor on the generation of internal funds has been analysed with the simple regression equation $Y = a + bx$. Stable availability of a particular source of finance is very important in choosing a particular source of financing. In order to ascertain the stability of different sources of funds, co-efficient of variation of
some sources having lowest co-efficient of variation is considered as the most stable source of financing. Electronic data processing (EDP) has been conducted through the software package in order to prove the relative bearing of the variables under study. Ratio analysis and correlation techniques have been used to know the impact of corporate tax on capital structure financing decisions of the corporate sector. The different techniques used in the study has been discussed in greater detail in the respective analysis chapters while testing the hypotheses.

Classification of the Sample:

We have taken 100 companies sample companies for the purpose of our study. In the sample, it includes different industry groups in the following manner.

<table>
<thead>
<tr>
<th>Industry Group</th>
<th>Number of companies</th>
</tr>
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<tbody>
<tr>
<td>Electrical</td>
<td>11</td>
</tr>
<tr>
<td>Tea</td>
<td>12</td>
</tr>
<tr>
<td>Jute</td>
<td>11</td>
</tr>
<tr>
<td>General engineering</td>
<td>16</td>
</tr>
<tr>
<td>Metal, alloys &amp; metals product</td>
<td>17</td>
</tr>
<tr>
<td>Chemicals, pharmaceuticals &amp; refineries</td>
<td>8</td>
</tr>
<tr>
<td>Silk, fibre, cotton, spinning &amp; weaving</td>
<td>9</td>
</tr>
<tr>
<td>Sugar &amp; Breweries</td>
<td>7</td>
</tr>
<tr>
<td>Paper and hardboard</td>
<td>6</td>
</tr>
<tr>
<td>Cement</td>
<td>3</td>
</tr>
</tbody>
</table>
The analysis of sample companies has been done for the total sample as well as for the industry group separately.

**PERIOD OF STUDY**

The period of study is confined to the years between 1980-81 to 1995-96. The study covers Sixth and Seventh Five-year Plan periods in regard to tax structure and other variables of the sample companies. The period has been chosen keeping in view the liberalisation policy, which was mooted in India in 1982 and took momentum since July 1991.

**Hypotheses of the study**

1) The higher the corporate income tax rates, the greater will be the preference for debt capital over the equity, the preference share capital.

2) The equity capital is influenced by the demand for additional finances to meet the expansion programmes of the company.

3) Internal funds play a significant role in financing the companies.

4) Retained profit plays an important role in the flow of internal funds.
Reasons For the Present Study:

Till today so far no study has yet been undertaken over the impact of tax structure and tax rate on the financial variables of the corporate entities in the industrial sector in eastern India. Hence the present study is a modest attempt to fill in the gap in the existing literature.

REVIEW OF LITERATURE:

Contrary to the popular belief, it is found that developed theories of public finance were available in ancient India. In this connection the supreme importance of *Arthasastra* can be realised from its attribute as the fourth Upaveda. During the age of Kautilya, we observe large number of direct and indirect taxes with major emphasis on direct taxes. The tax base was then much broader as tax could be paid either in kind or cash or in the form of services. In contrast to the resent compulsory nature of taxes, the taxes were then conditional payments to king for his services to the people.

Well-formulated economic thoughts are not of recent and of western origin, as commonly believed in general and by Indian economists, in particular. In fact, the word 'ECONOMICS' indicating the subject itself was first used by Adam Smith in England only two hundred years back. On the other hand, it is found that the equivalent word 'Arthasastra' in India was coined more than two thousand years
ago since the days of Kautilya. To be more precise, it may be relevant that the 'Arthasastra', which is a special and very important branch of knowledge dealing with artha or wealth or finance, has been mentioned as the fourth Upaveda (ayurveda, dhanurveda, gandharvaveda-cha-trayah-artha-sastram-chaturtham)\textsuperscript{1} in the ancient days.

Any study on the taxation follows from the nature of the state and the existing system of public finance. In ancient India it is found that the social structure was such that the scope of public finance was quite large as the state or the king had to perform a large number of widely varied duties relating to the welfare of the people.\textsuperscript{2} The concept of welfare state or the Rama Rajya already being existent, it is natural to counter with a host of taxes and complicated tax structure. In fact references of direct taxes like income tax, wealth tax, professional tax, labour tax, trade tax, pool tax, excess profit tax, irrigation cess, land tax and indirect taxes like octroi, toll charges, various cesses, customs duties, excise duty, salt tax, sales tax, gambling tax etc. were found to be in existence.

Apart from these, references of special type of taxes like bali kara, vastuka, rajju, chorarajju, klarpta, pindakar, pranaya, utsanga, senabhakta etc. were also

\textsuperscript{1} Atharva Veda Samhita, (ed) S. P. Pandit, (1895) (XLIX, 3); Arthasastra is considered as Upaveda of Atharva Veda.
\textsuperscript{2} Ranggopal, India of Vedic Kalpasutra. The Indian Economic Journal, No 4, vol.-37, April-June, (1990) p-134.
to be found. With revenues from all these taxes, the king was expected to maintain a sound treasury.

In Kautilya's version of the relationship between the king and the society, the ideas of modern social contract theory of state are found. It was mentioned that the taxes paid by the people to the king were nothing but his wages for his services to the people. If he fails to do his duties then the people also have the right to desert him and to rise against his authority to levy taxes.

During Kautilya's age, great emphasis was paid upon the importance of wealth and a sound treasury. Kautilya mentioned that wealth is really important as dharma and karma are depended on wealth for their realisation. He further described the treasury (kosa) as one of the seven elements of sovereignty (swamyamatya- Janapada-durga-kosa danda mitrani prakrityah).

Moreover, there were norms in those days that the king should impose taxes judiciously. The king must know when to tax and also on whom to tax (kamandakiya nitisara), he must know how to tax and what are the limits of tax (Santiparva, Mahabharata) and also he must know how much to tax (Arthasastra).

3. Bali had been described by Kautilya as special type of tax levied on villages, vastuka was a tax on houses and building sites, rajju was survey tax and choraraju was a police tax levied in the country parts as mentioned by Kautilya. Klarpeta was a tax levied on villages situated in sea-shore or banks of rivers. Pandakara was a tax in kind collected from villages as a whole. Praraya was an emergency tax. Utsanga was a tax collected on some specific festive occasions like birth of a prince. Senabhakta was a war time tax paid in the form of supplies to the Army.

4. In the Santiparva Mahabharata, it has been stated that if the king is unable to protect the people he should be described just in the same way as a ship, which had sprung leak in the mid-ocean.

5. Arthasastra of Kautilya - D. R. Sham Sastry, Mysore, (1928), VII.1
These norms together formed the principle of a just taxation. The guiding principle of the ancient Indian public finance was to tax upon the producer's surplus in such a manner that there is no decline in the level of production or there is no flight of capital from the country.

The ancient Indian taxation principle was mainly based on equal proportional sacrifice version of the ability-to-pay approach. The tax base of the older days was broader. The tax structure was more progressive too as more importance was attached to the direct taxes. The ethical aspect of taxation in ancient days is also very important. As the sun extracts water and returns it thousand fold in the form of rains, the king also is expected to collect taxes from the people and return them in the form of multiple amount of benefits (Raghuvamsam, 1.18). If the king collects the tax and does not perform his duties to the people, he gets in return a part or even whole of their sins (Mahabarata, santiparva, 69.25-26).

According to Manu, the great Hindu law maker, a king should make the traders to pay duty on their profits which should be fixed having regard to the rates of purchases and sales, the expenses for food and condiments and the cost of transport and other changes for receiving the goods. The king should fix the rates of duties and taxes in such a manner that both he himself and the man who does the work receive their due reward.
Adhya who studied the economic life of Northern India during a period of 500 years from 200 B.C. to 300 A.D. also pointed out that traders were taxed on the profits and net on the capital outlay.

According to Ved P. Gandhi, in India, as in most countries of the world, the corporation taxation varies according to (1) the tax base, i.e., 'total income' or 'distributed profits' or 'undistributed profits', (2) the form of organisation, i.e., private or public, (3) type of business, i.e., priority or non-priority sector and (4) the residence i.e., domestic or foreign.

B. R. Agrawal observes that on account of technical innovations and economies of large scale production, the role of corporate form of organisation and its contribution to the revenues of the government are quite significant.

P. R. Oza in his study feels that the rising tax cost burden on Indian companies is not only due to the increased earnings of the companies or the increased needs of the exchequer to finance the ever increasing role of the state, but also due to the fact that the state can only collect this huge amount of revenue from the docile and nerveless corporate sector while making the least possible

6. Adhya, G. L., Early Indian Economics - Studying the Economic Life of Northern & Western Indian, p-100.
demands on the voters, due to impersonal factor. This has made the government to transfer the maximum possible tax burden on the corporate sector.\footnote{P. R. Oza, "Corporate tax - Planning and Managerial decisions". The Indian Journal of Commerce, Vol. 24, March, (1971).}

According to Devenda Singh, corporation tax, as an important ingredient of the fiscal system, has a three-fold role to play: to transfer resources from the private to public sector; to bring about equality in income and wealth distribution, and to promote economic growth, stability and efficiency. From these angles, the corporation tax structure in our country is both a source of satisfaction and an object of criticism—a source of satisfaction, because it does not seem to have produced impending effects on economic growth and an object of criticism, because many still believe that the corporation tax rate in India are the highest in the world\footnote{Devendra Singh, Corporate taxation and industrial growth, Mittal Publishers, Delhi, (1985), p-6}. The modern form of corporate taxation is a tax on the undistributed profits of corporations embodying the principle of 'ability to pay'.

To quote the most celebrated American economist, Sir Seligman, "it (corporation tax) is just, it is simple, it is perfectly proportional to productive capacity. In short, it satisfies the requirements of a scientific system. Indeed, it is just, simple and scientific".

The corporate sector provides the best possible means to the government to ensure the maximum accountability to state, coupled with financial discipline,
administrative control and legislative regulation and direction of the activities in
the desired channels. 11

So far taxation of corporate profits is the most common form of corporate
taxation. Almost all countries of the world have adopted this system, though its
forms have varied. Briefly speaking, three systems of corporation profits tax are
adopted in the world today. They are the classic system, the split rate system and
the tax credit system.12

In almost all countries tax is levied on total corporate profits. In Austria,
Finland, West Germany, Japan, Kenya and Pakistan, distributed profits are taxed at
a lower rate. On the other hand, in Argentina and the United Kingdom additional
tax on distributed profits is levied. Except Greece, capital alone does not form the
tax base in any country. Tax based on capital is, however, imposed in Austria,
Costa Rica, Finland, West Germany, Italy, Kenya, Luxembourg, Norway, Spain
and Switzerland.13

Citing the great political philosopher Hobbes, Lord Kaldor has contended
that it may be just and expedient to tax people with reference to what "they take

11. S. Pramada Shah and Mrs. Narayan Shah, "Corporate tax and Modernisation of Industry". The
12. Under the classic system, tax is levied on total profits of companies at a single rate. There is
withholding of income-tax on dividends at a standards rate which is adjusted in the shareholders'
personal income tax liability. In the split Rate System, corporation tax is levied at a lower rate
on dividends than on retention. Under the tax credit system, the corporation tax is levied at a
single rate but part of the tax paid is counted as credit against income tax on dividends.
out of common pool" rather than what they contribute and has suggested that the consumption be a better tax base than income. 14

Raja J. Chelliah observes that in most developing countries including India, income taxation has grown up haphazardly, influenced by historical accidents, the example of other countries, the thinking of foreign rulers, and the exigencies of the moments. 15

In the classic words of Lord Loreburn, "a company cannot eat sleep but it can keep house and do business, and for purpose of income tax, a company resides where it really keeps house and does business, i.e., where the central management and control actually abides" 16.

Lord Kaldor, to bring a reform in the Indian tax system had recommended that "in place of all the present taxes on company income a single uniform tax ... should be levied 17.

The Matthai Commission, on the other hand, recommended for liberalisation of the provision in the law relating to "income deemed to accrue or arise in India as a result of business 'connection'" 18.

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The amount of corporation tax, i.e., the income tax paid by the companies is a significant contribution from the corporate sector to the Indian Exchequer. The rates of income tax on companies, both private and public, are very high and constitute a major portion of the total spending of a company.

The taxation of corporations is politically feasible and because of administrative convenience. It is quite easier from the political point of view to levy taxes on a few thousand corporations, which presumably do not vote, than millions of individuals.

Financial management perhaps best be designed as a function that touches upon all the other business functions. All business decisions have financial implications and not too frequently a single business decision may have impact on several parts of the organisation. In a developing country like ours decision-making plays a significant role.

The objective of the firm is to maximise its value to its shareholders. Value is represented by the market price of the company's common stock over the long

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19. R. N. Lakhotia, How to save income tax by tax Planning, p-399
run, which in turn is a reflection of the firm's investment, financing and the dividend decisions.22

The structure of company taxation in India is complicated and devoid of any sound basic principle. No wonder Kaldor was led to remark: 'The company taxation provisions of India (perhaps even more than that of other countries) are apt to strike a detached observer as a perfect maze of unnecessary complication of years of futile endeavour to reconcile fundamentally contradictory objectives'.23 In view of the tax reform measures recommended by Raja J. Chelliah Committee, it is, however believed that the government will rationalise corporate tax structure.

When the primary objective of tax policy is the promotion of private and public investment, the tax structure must satisfy canons somewhat different from some of the traditional rules of taxation developed for western economies. As Mrs. Hicks says: 'Naturally the outlines of a tax structure tailored for development will took substantially different in a conventional underdeveloped country than in a highly sophisticated economy like ours'.24

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23. Government of India, Ministry of Finance (Department of Economic Affairs), Indian Tax Reforms - Report of a Survey by Nicholas Kaldor, New Delhi, p-85
Limitations of the Present Study:

The present study could not cover many areas which constitutes its limitations. This has been indicted as follows:

a) The analysis has been confined to the acquisition and tax implications on fixed assets only.

b) Management of current asset and its tax bearing has not been looked into.

c) The study has been based on the figures of fixed assets (Gross Block) and tax provision made on the closing day of the financial year as contained in the annual report.

d) The figures contained in the annual report are valid only for that day and as such may not reflect the position during the year.

e) The sample size and nature of companies has been chosen for sample survey purposes. The selection of sample companies was based on the consideration of availability of annual report as published by Bombay stock Exchange in their official directory on a discrete basis for a minimum of fifteen year period with disregard to the size as well as age of the companies.