CHAPTER 3

ECONOMICS OF
CORPORATE TAXATION
AND
INDUSTRIAL GROWTH.
Introduction

The tax policy of any country is dictated not only by its economic needs but also by the political conditions prevailing within it. Over the past few decades, there has been a fairly elaborate and complicated structure of taxation in India affecting the corporate entities. The old-fashioned fiscal theory of taxation, aiming mainly at providing large revenue to the state, has since long been discarded and Governments in most developing nations have now come to realise the significance of ‘Functional Finance’ as an important part of shaping their fiscal objectives. After Indian independence, there was a radical change in the national Government’s attitude towards the tax structure and policy. Professedly, the dominant feature of our economic policy was the maximisation of social welfare. Not only revenue was to be collected, but such collection was also to conform to certain socio-economic policies aimed at achieving maximum social good. Thus the redistribution of income through taxation become one of the determinants of the economic policy of the Government. More recently, the feeling of urgency to find resources for the five-year plans has given a decisive twist to our taxation policy and tax structure. In this way new ideas and new forces are emerging, and these in their turn are influencing our tax policy and structure.
The basic goal of any developing economy is to increase the tempo of productive activity to provide certain minimum levels of wellbeing for the people. Key to this ultimately is higher production, which demands increasing investment, adoption of advance technology and fullest development and utilisation of human skills. The main objectives of the fiscal policy has necessarily to be to ensure an adequate growth of Per-capita output, capital generation for a higher rate of industrial growth and adoption of modern technology. The tax structure in particular should foster the maximum use of domestic resources, creation of domestic technology, raise productivity and ensure equitable distribution of the fruits of progress.

Industry is the most dynamic sector of the economy, where productivity increases at a rapid rate if the necessary pre-requisites are ensured. Industry assists agricultural development by supplying necessary incentive goods in exchange for agricultural produce. As industry assists the development of other sectors by providing a steady supply of wage goods and by generating skills and organisation, it's rapid expansion remains vital for achieving the postulated growth. The fiscal instrument can lead to a steady growth with reasonable price stability. There are a wide variety of objectives which tax policy could pursue and there is after a basic conflict between the different objectives. Tax policy must, therefore, constitute a compromise between the various diverse objectives. The nature of that
compromise must change with economic growth and progress. In the past, corporations have played no mean part in the economic life of our country. Whatever economic development has been achieved in India, the credit for it must undoubtedly go in large measure to the various joint stock companies functioning here, on the whole with vigour and fruitfulness. Taxes being a major factor that affects the working of the corporations, it is a sine qua non of their future success that corporate taxation should be so conceived and applied as to cause the minimum ill-effects on the functioning of the corporations. Corporation tax, as one of the important 'direct' tax weapons in the hands of the Government armoury, can be made to subserve a number of national policy objectives. In this chapter an attempt is made to explain the meaning and history of corporation, rationality of taxing the corporations, method of taxing them and the results emerging from the imposition of taxes on corporations.

Meaning of Corporation:

The word 'corporation' comes from the Latin corporate, ultimately based on a Sanskrit root meaning 'to form into a body'. A 'corporation' has been defined by the Encyclopaedia of Social Sciences as "a form of organisation which enables group of individuals to act under a common name in carrying on one or more related enterprises, holding and managing property and distributing the
profits or beneficial interest in such enterprises or property among the associates.... its shares are transferable; its life independent of the lives of the individuals; its debt do not usually create a liability for the latter". This is, of course more than a mere definition; it is almost a complete description of a corporation, which is really a voluntary association of certain people who pool their resources together and undertake some kind of activity – generally business or trading – for the express purpose of making profits. If the members of a corporation choose to function thus, it is because of many benefits that this form of organisation confers on them. The foremost of such benefits, no doubt, is the principle of limited liability and the comparative immunity deriving therefrom. It is, perhaps for this reason that the corporate form of organisation has become so popular feature of the world of business, and in all countries with a ‘free’ economy the corporation is almost the dominant type – the ‘archetype’ as it were – of the business structure. A part from this specific economic role, the corporation, because of its general currency and wide popularity, brings in its wake numerous social problems as well. Hence it is not surprising that Adolf Berle and Gardner Means (1948) should declare: The corporation has become more than a method of doing business: it has assumed the aspect of an institution of social organisation comparable to the state itself".

Early History Of Corporations:

There is a common belief among many in this country that corporate type of business organisations were brought into India by British merchants and the modern corporate society of India owes its antecedents to Great Britain. A close look at the economic history of ancient India, however, reveals that corporate form of business organisations were not unknown in pre-British India; at least a genesis of corporate like business organisations, as was the case with all other countries, resembling to some extent a modern corporation, existed in the ancient Indian business field. The earliest form of corporate enterprises was in the nature of guilds. It appears from some comments of Mitramisra that the inclusion of new members in a guild and the exclusion of old from its fold depended upon the general assembly of the guild. The new member at once share, equally with others, the existing assets and liabilities of the guild and enjoy (sic) the fruits of its charitable and religions deeds, whereas the man who was excluded from the guild would at once cease to have any interest in any of them.

Gradually, such guilds or business organismations come to be recognised by the king, which were to some extent akin to a company chartered by the crown. The merchants, specially of South India, were also distinguished for their corporate organisations. An inscription dated 592 A. D., belonging to the Gujrat-Kathiawara region records that a community of merchants approached the king...
with the request of being favoured with his āchāra – sthiti – patra which they might utilise in protecting and favouring their own people. The king granted such a document containing a long list of regulations, adding at the end that he also approved of other āchāras that were handed down from ancient times. This is in full agreement with the injunctions of the sāstras that the king should recognize the customary laws of guilds, corporation’s etc.

In the words of Rungta: “The ancient indigenous institutions of the guild type and the territorial groups of businessmen and artisans, plausibly regarded as akin to modern companies, had almost withered away by the end of the fifteenth century in the wake of political disturbances preceding and following the advent of European Merchants on Indian waters.” The ancient indigenous institutions of the guild type and the territorial groups of businessmen and artisans, plausibly regarded as akin to modern companies, had almost withered away by the end of the fifteenth century in the wake of political disturbances preceding and following the advent of European Merchants on Indian waters.”2 Thus, in his opinion: “Modern business corporations in India owe their existence to foreign influence and traditions. It was mainly from the operations of the European chartered companies that the Indian merchants learnt about this from of business organisation.”3 This was to some extent true for the growth of modern type of corporations with common attributes such as limited liability, a common seal and perpetual succession.

The rise of corporate form of business organisations in foreign countries was, however, made possible not due to any superior business skill and methods of those people but out of sheer necessities. Consequent on the opening of trade route

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2. Rungta, R.S. : The Rise of Business Corporations in India –1851-1900, P.1
with India, it was found practically impossible to carry on such a fast expanding trade with individual efforts and as such Queen Elizabeth chartered the first English East India Company on December 31, 1600. The Dutch East India Company was formally instituted in 1602. The first French East India Company was formed in 1604. In 1606, a Royal charter created the London and Plymouth companies.

It is significant that the first permanent British settlement in America came in the form of business endeavours that is in the form of chartered companies. In course of time the settlers used to grant their own charters and in the early 1790’s such procedure was becoming routine. But this was not so in the world’s leading business nations, namely France and England. The rapid use of corporations, 300 of which were chartered by 1800 in America when France and England had only a score of them, resulted from the American situation. A general incorporation Act, for the manufacturing companies was passed in New York in 1811. A Massachusetts Law of 1830 established the principle of limited liability for corporate shareholders.

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3. Ibid, p-1.
5. Ibid, p-5
6. Ibid, p-5
7. Ibid, p-5
While it is clear that corporations came to be organised during the eighteenth and nineteenth centuries, the early origins of corporations are lost in remote antiquity. A. B. Levy, however, traces the origin of corporate form of organisation to the 'code of Hamurabi' (2075-2025 B.C.).

As Justice Black stone has pointed out, the corporations were first invented by the Romans. The corporations for the first time came to be organised during the eighteenth and nineteenth centuries. A good number of corporations were noticed during the period of the Industrial Revolution in England. The corporations played a vital role in galvanising the economy during the eighteenth and nineteenth centuries. The corporate sector in our own times is merely a phenomenal expansion of the eighteenth and nineteenth centuries corporations.

**Popularity of the Corporate Sector:**

The undoubted popularity of the corporate form of organisation is due to the mystique of the corporate personality. The principle of limited liability is equally responsible for the vogue of the corporations. Once a corporation is established, it ceases to be the absolute property of any one individual. Numerous individuals can jointly own the corporation, but individually they can claim ownership of only an infinitesimal part of the whole. This is how a corporation

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becomes a separate 'artificial' or 'fictitious' entity or individual. In this artificial-
legal form, the corporation is entitled to be treated as if it were a person indeed.
Actually, however, it would be more appropriate if the corporation were described,
in Richard Goode's words, as a "mere conduit through which legal and economic
relation flow between shareholders and others". Thus a corporation has the right
to purchase and sell property and to prosecute and defend itself in a court of law, as
if it were an ordinary human being. But it is a person in the legal sense, as distinct
from its shareholders, managers or employees. The corporation is also in itself a
deathless entity, for it can cease to exist only if the people who own its shares
'will' its death and take the necessary legal measures. It is sometimes compared to
a river because, just as a river is the same river "though the parts which compose it
are changing every instant", so also a corporation is the same corporation,
though the people who own it may change from time to time. Thus the corporate
personality is similar to and distinct from the individual personality. Just as an
individual earns and pays taxes, the corporation also earns and has to pay taxes.
But there are certain things, which an individual does which the corporation can
not do. They are the emotions and reactions. Moreover, the foremost trait of the

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modern corporation, according to Berle and Means, is the separation of ownership and control.\textsuperscript{12}

Numerous theories have been put forward which seek to justify the existence of corporations and at the same time to sound the origins from which sprang the idea of the corporation. According to the 'sovereignty' theory a company \textsuperscript{13} is regarded as a fictitious person because the state has allowed such an assumption. Hence corporations exist because the state (sovereign authority) authorises their existence. However, another theory says that, when a few persons join in a contract, this creates a unity of purpose, an organism possessing a common will or determination. Thus, according to this view, corporations are group of persons and not individual persons, however unreal or fictional; the corporation is really no more than a method of cooperative effort. Another view holds that the corporate personality is just a convenient short-hand expression to convey certain attributes of these associations of persons. Another connotative relevance in calling the corporation a 'person' is to emphasise the fact that "it is a financial and accounting unit": that is to say, it is a unit for the purpose of computing cost and measuring income. These attributes of the corporation are

\textsuperscript{13} As the words company and corporation are synonymous, the words are used interchangeably throughout the study.
responsible for the increased popularity of this form of organisation in the economy.

Why Should Corporations be Taxed?

A Company has to pay two important taxes on its income. They are income tax and Sur tax. Apart from these taxes, a company has also to pay 'Capital Gain Tax' on the sale and transferability of short-term and long-term assets. The corporate form of business organisation, compared to other forms of business organisation is of recent origin. If one considers the historical background for imposing direct taxes on corporate income, it will be observed that it was introduced mainly as a complement to the direct tax on personal income and later was chiefly continued on revenue considerations. In the words of Cosciani, "it is quite significant that the corporation tax, as a tax independent of other taxes on income, comes into being at the moment when a graduated personal income tax is introduced and naturally at the same time that joint stock companies begin to develop. If we read the parliamentary debates on the various tax laws, we shall see that one of the grounds relied upon the introduction of this tax is purely the 'Question of raising revenue'". But as the tax came to be continued and assumed an almost permanent role in the financial system of most advanced countries, the
theoreticians, more particularly the authorities on public Finance, started a Quest for a theoretical Justification for the continuance of the tax.

Numerous texts, anthologies have not only attempted to deal with the basis on which corporations are taxed. But also, almost all the authorities have said something about the rationale behind the imposition of such tax. Although several answers have been formulated, but none of them is completely satisfactory. As Ambirajan puts it, in practice, all taxes are motivated variously and have diverse and mixed objectives. On the whole, the ends-be the financial, social, political or economic-should justify the imposition of tax.\textsuperscript{15}

According to Taylor, "a more elaborate and more recent statement of the theory of business taxation justifies business taxes separate from those on property, personal income, and consumption on 'one or the other' of these eight grounds (1) Special privileges (licenses, French; sees, or charters) conferred by the state on certain types of business; (2) Special services (inspection of dangerous equipment, special protection) rendered to certain businesses; (3) general services (Protection of property, enforcement of contracts, public education, public improvements, etc) rendered to all business; (4) Social costs or losses (destruction of national resources, pollution, overcrowding industrial accidents, technological

unemployment, etc) resulting from certain business operations; (5) impersonal tax paying capacity of business; (6) general welfare (a means by which to tax the general public through the price system; (7) Social expediency (revenue productivity, ease of administration, popular acquiescence); and (8) exercise of desired social controls (discouragement of imports, chain stores, excessive profits). Here the whole amount of tax justifications appears: benefit, cost, ability, revenue productivity, and control."\(^{16}\)

The most frequent criticism of the present corporation income tax is that, in combination with the individual income tax, it results in double taxation of the same income, namely, once in the hands of the company and again in the hands of the shareholders.\(^{17}\) This argument is based on the assumption that a company is only an agent of its shareholders and has, therefore, on income of its own. All taxation being invariably personal taxation, a corporation is not a person\(^{\dagger}\) in this strict sense of the word-made of blood and flesh-to pay taxes, and therefore, it is argued that due tax credit must be given to holders of stock for the tax paid by the corporation. Greece, for example, is one country where this view has been followed and tax credit is allowed there to stockholders for the taxes paid by their


corporations. In India also, till the assessment year 1959-60, compound system was in existence and partial credit was allowed to the stockholders in respect of taxes paid by their corporations. As per the provisions then existing under the Income Tax Law, the income - tax on companies was refunded to the stockholders on distribution of profit but the supper - tax was treated as non- refundable. Many people believe that businesses should make some payment to the government for benefits received. Taylor quoted the observations of the National Tax Association of the U.S.A. to justify business tax relating to cost, which read as under: “the benefits enjoyed by corporation in common with other forms of business organisation by virtue of numerous government activities contributing to the establishment and maintenance of a favourable environment in which to carry on business activity.”

Moreover the charter of incorporation makes a corporation distinct, from its stockholders – and ‘artificial’ or ‘fictitious’ person – with a distinct capacity of its own to pay taxes. Incorporation confers definite legal privileges on a corporation such as limited liabilities, easy transferability of stocks and the safe

17. Jain, Anil. Kumar., Taxation of Income in India., The Macmillan company of India Limited, Delhi, (1975)., P-76.
type of sleeping partner,\textsuperscript{21} and therefore, a corporation must pay for these privileges. In the legal sense, the company and its shareholders are different persons and have separate incomes. Both in India and the United Kingdom the courts have held that the tax paid by a corporation is paid by it as a separate entity. In the case of Mrs. Guzdar Vs.C.I.T. Bombay, the Bombay High Court observes: “Not only are a company and a shareholder separate and independent entities under the general law, but even under the Indian Income Tax Act a company is a separate entity for the purpose of assessment from a shareholder. A company pays income tax in its income or its profits. It does not pay income tax on behalf of the shareholders.\textsuperscript{22} The Corporation has a life quite independent of the lives of its shareholders. A Corporation is the same corporation, though the people who own it may charge from time to time. It is sometimes compared to a river because just as a river is the same river, “though the parts which compose it are changing every instant,”\textsuperscript{23} The Taxation Enquiry committee in India, also argued at some length the distinct economic as well as legal significance of corporations and defended the suitability of corporations as a separate subject of taxation.\textsuperscript{24}

\textsuperscript{22} (1952) 221. T. R. 158
As against this, Dr Bhargava\textsuperscript{25} objects the "Privilege" criterion of taxing corporations as 'illegitimate' and 'unscientific'. He writes "It is a poor and unscientific theory of taxation that justifies taxes on the basis of rights or privileges created or granted by the state, and if the corporation tax is a tax on privilege it should be levied when the privilege is granted, that is, when the joint stock Company is incorporated. It should also be related to the privilege granted. But the corporation tax bears no such relationship. The tax is not levied so long as a corporation incurs losses. This naturally gives rise to the cost theory of corporation taxation."

Dr Bhargava believes that corporations pay (corporate) tax due to their capability, which include large resources, capacity to take greater risk, bigger investment and proportionately larger incomes. These factors create 'taxable capacity' to corporations, in addition to its ability as reflected in the income of its stockholders when its profits are distributed to them. Similarly Lord Kaldor on general equity considerations finds it difficult to accept the view that the taxation of corporate profits should be treated distinctly from the taxation of individuals. Though in a corporation, particularly in a large one, stockholders have practically least say as to the extent of distributed or undistributed profits, "this dose not alter the basis fact that it is the shareholders who benefits from the undistributed profits

of companies, and that the tax imposed on the company must ultimately reduce the
net benefit accruing to the shareholder in much the same way as a tax on his
dividend income, or on his capital assets. The benefits accruing to the shareholders
takes the form of capital appreciation. Since undistributed profits represent an
increase in the net resources (they) .... tend to increase the market value of the
shares in a corresponding manner. 26

Despite the fact that Lord Kaldor's argument carries substantial weight,
the logic that corporation has an independent capacity of its own to bear taxes, has
become a recognised principle in the tax system of the most countries of the world
today. Moreover, positive economic justification of a separate corporation income
tax has been based on: (1) The benefit of privilege theory; (2) use of the tax as a
means of improving the allocation of social costs; (3) the ability to pay principle;
and (4) Use of the tax as a means of social control. 27 The above mentioned grounds
on which corporations are supposed to be taxed seem to have some truth in all
these pleas. Separate taxation of corporate income arises primarily out of the
financial needs of the government. In the words of Dr Roy "In a modern economy
the corporate bodies are generally identified with big business having a taxable
capacity of its own higher than the taxable capacity of its owners. Moreover, being
of an impersonal nature, corporation tax would cause little vexation in the public

27. Goode, Richard; (1951) op. cit. PP - 27 - 40
mind and due to the standardised system of account keeping it will be relatively much cheaper in raising tax from them. It is, therefore, no wonder that legislators, particularly a band of elected politicians, either knowingly or unknowingly, would increasingly place heavier reliance on corporation tax for raising the desired amount of revenue.»

It is obvious from the above discussions that none of the theoretical tax justifications can properly justify the corporation tax on a purely scientific level. As Goode has said: "In practice all tax systems and virtually all particular taxes are working compromises of competing claims of equity, economic desirability, administrative feasibility, and political expediency."  

After considering the various grounds on which corporations are supposed to be taxed, it can be concluded that not one of the above pleas can exclusively form the basis of taxation. But now, the taxation of corporations has become a regular, universal and an almost indispensable feature of the tax system, economists are trying to find a rational basis for it. Having come in to the tax structure, it has remained there; even though, revenue could be raised in other ways still corporate taxation is being retained because the modern state, with its endless extension of functions, can never have too much finance. The modern form of corporate taxation is a tax on the undistributed profits of corporations embodying

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the principle of 'ability to pay' and 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\textsuperscript{31}.

\textbf{How Should Corporations be Taxed?}

It is common folklore that we live in a corporate world, and that there is an
incessant search for an alternative paradigm of taxing corporate income. In almost
all countries of the world tax is levied on corporate profits or income. Therefore,
discussions on the system of corporation taxation have often been confined to
alternative system of taxing corporate income so as to allow for differentiating
between distributed and undistributed profits, avoiding double taxation of
distributed profits, taxing of closely-held or widely-held companies, or
intercorporate dividends, etc. However, recently capital and value added as tax
bases for corporation taxation have been given serious consideration. Taxes could
be levied on the gross sales, as an alternative basis of taxation. The following
paragraphs examine the merits and demerits of these alternative bases and see
whether the present system of taxing corporate profits be replaced by any other
alternative system.

Tax on Gross Sales:

Not seldom a tax on gross sales is described as the most equitable form of corporation Taxation. In this regard, seligman says emphatically: “The value of the franchise from the economic point of view consists in the earning capacity of the corporation. That is the real basis of all taxation and can best be gauged by the amount of business done.”\(^{32}\)

No doubt, such a tax would bring certainty in Government revenue and evasion of tax would become relatively difficult. But this tax, although it has an immediate appeal, is not with out its drawbacks. Such a tax would largely be a tax on initiative and risk – taking and would favour relatively inefficient and inactive firms. Even Seligman who favoured the tax on equity grounds, was extremely sceptical about the validity of the tax in practice. This is evident from his statement that “The business transacted is an exceedingly rough way of ascertaining the prosperity of a corporation. It affords no test of profits, and fails to take into account the personal equation, which may make all the difference between good and bad management."\(^{33}\) Further, such a tax would place heavier incidence on concerns whose turnover of capital is higher and would also add directly to the

\(^{32}\) Ibid, p- 237.
\(^{33}\) Ibid - p-243
costs of production which would, in turn tantamount to sales tax. In India tax on
gross sales can be imposed only by the state Governments.

**Tax On Value Added:**

Value added concept of income is not a new one. It is a concept developed
by economists; but of late, it has been used by accountants. So far business
enterprises were preparing profit and Loss Account or Income statement to know
the amount of profit earned. With the increased social awareness it was realized
that business should disclose its social responsibilities towards the society.

There are two views of value added, one propounded by Accountants and
the other one by the Economists.

In accounting, “value added is the excess of sales revenue plus income
from services over the cost of bought in goods and services purchased from
outsiders. The economists take a macro view of the value added. As per the
economists the addition during a specified period of time in the Gross National
Product is the value added by the nation. The figure of the value added, therefore,
indicated the increase in the social welfare, as such the figure of value added is
used to judge social welfare in economics. The Institute of Chartered Accountants
of India defined the term Value added as “The increase in market value resulting
from an alteration in the form, location or availability of a product or service
excluding the cost of bought in materials and services\textsuperscript{34}. J. L. Brown and L. R. Howard aptly defined the term value added as "Sales value less the cost of bought in goods and services used in producing those sales"\textsuperscript{35}. John Sizer stated that "value added is the wealth the company has been able to create by the own and its employees' efforts during a period"\textsuperscript{36}. He further stated that "It is out of the 'value added cake' that a company rewards its various stockholders, that is shareholders, directors, managers, employees inland revenue etc"\textsuperscript{37}. According to Richard Lewis, "value Added May be Calculated as the difference between the value of goods or services produced by the team, that is sales revenue less the value of the goods and services purchased from outsiders, that is, the cost of bought in materials and services"\textsuperscript{38}.

On the basis of the above views it may be concluded that value Added is the wealth created by a business. It measures the business performance and manpower productivity. It may be stated that the figure of value Added is more reliable to measure, evaluate and judge the efficiency of an enterprise than the figure of profit because it excludes those costs over which the concern has either no control or at best a little control.

\textsuperscript{34} Glossary of The Institute of Chartered Accountants of India, Sept. (1983).
\textsuperscript{37} I bid., P- 35
Under the value-added tax, the value-added by a company may be computed "by deducting the value of the materials and supplies purchased from outside, depreciation and indirect taxes from the gross receipts of the company. It will include profits, wages, salaries, interest and rent"\textsuperscript{39}.

The justification for value added tax rests primarily on favourable effect that it is likely to have on the efficiency of the organizations. This tax would be neutral between factor costs and profits and therefore, between efficient and inefficient firms as opposed to income tax which has the effect of shielding inefficient units. A value-added tax is economically neutral between capital intensive techniques of production and also between vertically integrated and disintegrated firm. V. P. Gandhi says "From the social point of view the tax on value – added distributes the burden of business taxation in proportion to the Use of the society's resources rather than profits earned"\textsuperscript{40}.

However, there are a number of problems in adopting this tax. Firstly, value-added is not as satisfactory yardstick of a company's taxable capacity. Secondly, a value-added tax is like turnover tax or sales tax and is, therefore, likely to be inflationary and regressive. Thirdly, it may also add to the already heavy burden of indirect taxation. Fourthly, the concept of value-added is not understood

\textsuperscript{40} Ibid p-115
by the people in general and its imposition is likely to create serious administrative difficulties. Finally, the imposition of the tax would act as a competitor to the retail sales tax imposed by the state Governments and therefore impinge on their ability to raise revenue though sales taxation. Hence, state Governments are also likely to oppose the imposition of the tax.

**Tax on Capital:**

It is for the first time, in India, that Bhoothalingam and Wanchoo committees gave serious consideration to treating capital as a tax base for taxing companies. Bhoothalingam suggested one percent tax on all capital mobilised for capital use. The Wanchoo committee has also proposed one percent capital levy as a supplement to the corporation tax. capital base for this purpose would comprise ‘owned’ as well as ‘borrowed’ capital, ‘owned capital’ has been defined by the committee as “paid – up capital of the company and reserves, other than reserves for specific contingent liabilities” and ‘borrowed capital’ as “an amount calculated at eight times the net interest paid by the company towards borrowing during the year”\(^{41}\).

The committee points out that a capital levy would discourage ineffective and wasteful use of capital. Further, a tax on capital would rationalise the scheme

\(^{41}\) Direct Taxes Enquiry Committee Final Report, Manager of Publications, MINISTRY OF Finance, New Delhi, Vol. II (1971) P – 125,
of company taxation and would incidentally check the avoidance of wealth – tax through the medium of closely held companies. A capital levy on both owned and borrowed capital of a company would act as a check on avoidable capital expenditure and on borrowings. It would discourage unnecessarily large inventories. Further, such a tax is neutral between risk capital and borrowed Funds.42

However, there are a number of theoretical and practical problems involved in adopting this levy at the moment. An annual capital levy would amount to an extension of a similar tax – property tax or wealth tax – on individuals. For individuals, it is true that “If a property does not yield money income, it must either yield an equivalent psychic income to the owner or it must be held in the expectation of a certain appreciation in value”43.

But this principle is neither appropriate nor has any justification for corporate taxation. In fact income itself is the source of capital value. As seligman neatly puts it, “Physically, the fruit is the product of a tree, economically the tree has a value only because the fruit has a value”44. An annual capital levy would not necessarily ensure a more efficient use of capital as it may amount to direct addition to overhead costs and under the present inflationary conditions, may be

42. Ibid. P – 115.
passed to the consumers. Besides, if the object of the levy is to discourage ineffective and wasteful use of capital, then the Monopolies and Restrictive Trade Practices Act, Industrial Development and Regulation Act, and security Exchange Board of India Act, which are already in existence to regulate the use of capital in India will be redundant.

Such a levy would discourage highly capital intensive business such as steel, heavy chemicals, petro-chemicals, etc., which need to be developed even further and discriminate between firms of equal profits but unequal capital intensity. The levy would discriminate between old and new units in the same industry as old units with depreciated plant and machinery would feel relatively less burden as compared to the new units. Besides, profit margins of the capital intensive industries which are subject to price control by the Government would be squeezed further and less profits would be left for ploughing back. As public corporations and enterprises would also be covered by this levy and majority of them are running in losses, the levy would increase their losses further and create strong public opposition. Capital levy together with the corporation tax will increase the tax burden, so the business community may be inclined to opt for other types of business such as partnerships. This would go against the Government's policy of encouraging the company form of organisation. The levy
might also drive capital from industry to agriculture and commerce and encourage speculative investment in real estate.

The problem of capital levy is that it taxes only the physical capital and not the earning capital, otherwise known as 'brain capital.' In any scheme of taxing the capital stock, the main problem is the valuation of capital assets. Seligman also feels that to tax corporations on the basis of the capital assets at its market value is open to serious objections. He feels that "heavily bounded corporations would in this way escape taxation; because in such cases – and they are the great majority – the capital stock alone would not represent the value of the property." If a corporation that has no bonded debt distributes dividends, then the value of the stock would be a fair index to its earning capacity. But if the corporation distributes no dividends then there is little scope to determine the value of the capital assets. It would be "wholly uncertain and largely speculative, depending on the manipulations of the stock exchange."

Moreover, under the present inflationary conditions, unless there is an annual valuation of capital assets, the burden of the levy would be heavier on new enterprises. An annual valuation of all capital assets does not seem to be a practical proposition under the present circumstances. Already, in the case of wealth tax on

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46. Ibid – P – 239.
individuals, a number of cases have been directed where there has been incorrect valuation of properties. The imposition of capital levy would worsen the matter.

**Tax on Profit or Income:**

Profit as the base for taxing corporations is the most common form of corporate taxation. Almost all countries of the world have adopted this system, though the forms have varied. The systems of corporation profits tax which are adopted in the world today are the classic system, the Split Rate system and the Tax Credit System.

Opponents of company profits taxation say that tax on company profits puts a premium on debt financing and discourages equity and risk capital. It penalises efficiency, reduces internal liquidity and net reward of capital.

Undistributed profits has become a major source of finance to the corporate sector for augmenting their capital resources which result in hastening the economic development of the country as a whole. To quote cosciani, “In modern economy company profits placed to reserve represent a very substantial proportion of national savings and, in fact exceed – as we have just stated – the

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48. 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 standard 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 retentions. 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.
amount of private savings that companies with share capital absorb on the market as a result of issue of new shares or bonds. In India a vast majority of private companies who can not reach the national capital markets through the medium of recognised stock exchanges and a large portion of public companies, particularly at the initial stages of their development, rely mostly on undistributed profits for capital formation.

In recognition of the useful role of undistributed profits in capital formation, T.T. Krishnamachari, the Finance Minister of India, while presenting the interim budget on November 30, 1956, inter alia, observed: "The problem of raising resources for investment has to be looked at both from the point of view of public sector and of the private sector. Just as an increase in Public Savings is necessary for financing investments in the Public Sector, an increase in corporate savings is required for meeting the needs of the private sector. A personal saving is undoubtedly important, but individuals can hardly find the large-scale investment that is needed for the private sector. There is a trend in the industrially advanced countries of Western Europe towards greater reliance on corporate savings. The main source of capital for private enterprise in these countries is savings effected

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by industry itself, supplemented by funds obtained from other institutions in the field of industrial finance.\(^50\)

In view of the general beneficial role of undistributed profits in accelerating capital formation which immediately exposes itself to productive adventures, Governments of almost all countries have granted tax concessions, in some form or the other, in favour of undistributed profits: at least the portion of the profits which are distributed as dividends are taxed more heavily. However, this creates two major problem in the field of appropriate taxation of such profits. Corporations are nothing but juristic personalities and the profits earned by them are for all practical purposes earned for the beneficial owners only. The portion of the profits which are not distributed as dividends creates a problem of its integration with appropriate personal taxation and the reasonableness or otherwise of the accumulation of profits by creating reserve funds.

Various schemes have been suggested for the integration of corporate and personal taxes so as to avoid undue tax avoidance through corporate profits retention. The more important suggestions are as follows:

1. To treat the Corporations like partnership. Allocation of Corporate earning (or losses) among stockholders on a pro rata basis, according to the shareholdings

\(^{50}\) The Statesman, Dec 1, 1956.
and consolidating such earnings (or losses) with other personal income for personal income taxation.

2. To remove corporation income Taxes, but shareholders should be rigorously taxed on the basis of realized capital gains, even if such gains are not realized until the death of shareholder.

3. To use some adoption of the British income-tax system, under which a corporation acts primarily as a withholding agent for tax due on the individual incomes of its shareholders.

4. To use an undistributed-profits tax at very high rates in lieu of other corporation income taxes.

5. To free the corporation from income taxes on income which it distributes in dividends, but impose a heavy tax on retained earnings which are 'uninvested'.

The above suggestions have been widely debated in different forums. While the integrationists argue in favour of a single comprehensive income tax that treats all kinds of income in the same manner, on the other hand the separatists maintain that the separate corporation income tax is an indispensable aspect of the tax regime. According to the separatists, the corporation tax is firmly in place and continues to be a highly productive source of Government revenues. However, none of the arguments on either side can be accepted uncritically. The principal features of the schemes and their limitations are discussed below.
As regards the Pro-rate distribution of corporate profits / losses to individual shareholders for taxation at appropriate personal rates, the integrationists say that Pro-rata distribution of corporation income to individual shareholders would be a sure way of dealing with the problem of discriminatory treatment of personal incomes for tax purposes and thereby reducing to avoid some taxation of personal income. Separatists have, however, expressed very serious doubts regarding the practical application of the proposal. Ambirajan says: “On paper, this method appears to be sound and logical. For practical application, however, the scheme presents many difficulties. Moreover, the scheme does not take into account the personality of the corporation as such, which is real in its own way. But apart from this objection, the difficulties inherent in this method make its application next to impossible. As a general rule, corporations have hundreds or even thousands of shareholders, and it would be a terribly complicated task to allocate the profits and losses between them all. Besides, some listed stocks pass from hand to hand too often to permit the fixation of ownership for a given year on one person.”51

Regarding the scheme for a tax on realised capital gains, even though Kaldor argues in favour of the tax, he is not blind to its deficiencies, especially the

facility it gives to individual capitalists to indulge in irrational and antisocial behaviour.\textsuperscript{52} 

The withholding approach has been commended by the integrationists on the grounds that, it would consider all or part of the corporate tax as a withholding tax or an advance payment on the liabilities of the stockholders, as a result it could completely equalize taxes on distributed corporate profits and other forms of income. Taxes could be entirely eliminated on dividends going to nontaxable shareholders and the same tax imposed on other dividends as on interest and other kinds of income. Further they argued that the withholding approach could reduce or practically eliminate the tax discrimination against equity financing and against the corporate form of organization. The withholding approach practice was, in part, in operation in India till 1960-61. When corporate dividends were taxed at appropriate personal rates and undistributed profits at the rate applicable to corporations. Taylor, commenting on withholding approach says "The corporate income tax has been a heavy revenue producer to the Federal Treasury, and the sacrifice of this revenue, under conditions of high budgetary expenditures, and high public debt, is not to be taken lightly"\textsuperscript{53}. The caution expressed by Taylor would be far more true in the case of India with a high degree of developmental expenditure and consequential insatiable appetite for revenue by the public

\textsuperscript{53} Taylor, Philip. E., Indian edition (1968) op cit., P- 423.
authorities. Moreover, tax rates are a problem of this method. To Quote Ambirajan, "If tax avoidance through the accumulation of undistributed profits is to be prevented, then a high withholding tax (equal to the top bracket personal tax) in a necessity. But this is sure to produce deleterious effects on corporate enterprise. Accordingly, there must be a correlation between the individual income tax rate and corporate tax rate for the successful application of this approach"\textsuperscript{54}. There is yet another objection to this method in that it produces substantial advantages only to the shareholders in the top income bracket by not requiring them to pay the appropriate rate of tax on that portion of corporate profits which were put to reserve. The method therefore, can not be made equitable in its application.

The other method suggested for dealing with the problem of large accumulations of undistributed profits in the hands of corporations is the imposition of a high-undistributed profit tax in place of the corporation tax. The integrationists argued that under this system a considerable amount of current income is not withdrawn from the income stream as a result of withheld corporate earnings which are not reinvested. There is however, one most valid argument against this method of taxing undistributed profits of companies. As Ambirajan points out, this method ensures lesser tax avoidance through undistributed profits but "The difficulty with this scheme is its bias against small and expanding

\textsuperscript{54} Ambirajan, S. (1964) -- op. cit. P-53.
corporations because, where as big and established concerns will be able to distribute large dividends, smaller concerns will have to depend upon the ploughing back of profits for expansion55. This method of taxation would certainly put a break on savings at corporate level which is an accredited means of means of corporate capital formation in all countries, and more so in developing country like India where capital is very much scarce. To the extent that monetary and fiscal policies have an inflationary bias, as they have in India, the owners of equity capital benefit at the expense of the owners of debenture or preference capital in the long run. Since almost all countries have provision of carry forward losses, the discouragement to risk taking is counter balanced. Further Economic development depends not only upon the rate of capital formation but also upon the introduction of new methods and new products. This requires that new firms should also be encouraged. The argument that a company profits tax reduces internal liquidity is in fact an argument against profit as a base of taxation. The problem can be tackled by inserting incentive provisions in the tax system.

In a tax system in which personal income tax rates are higher and capital gains are taxed lightly, closely held corporations are encouraged to retain earnings and eventually realise capital gains on them. Hence, a penal tax on undistributed profits of closely held companies is justified. Besides, to the extent corporate

55 Ibid.
profits are taxed, equity is achieved between shareholders as a class and the rest of
the community. Further, the tax burden is distributed in a progressive fashion
because the bulk of the shares are held by persons in the higher income brackets.
As demonstrated by Richard Goode, the tax structure as a whole is more
progressive with the corporate tax than without it.

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
lower rates. On the other hand, in Argentina and the U. K., 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.

**Tax on Excess Profits:**

In recent years sub-tax on corporate profits, which is nothing but a variant
of the excess profits tax, has been a permanent feature of the direct taxes on the
corporate profits in India. Historically speaking, the taxation of excess profits in
respect of corporate enterprises in India began for the first time with the
introduction with the introduction of “The Excess Profits Duty Act, 1919. To

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56. Goode, Richard (1951), op. cit. Ch. 5.
supplement the war efforts of Great Britain in the world war I, an Excess profits Duty was imposed on business profits in Indian for one year only and was operative from April 1, 1919.\textsuperscript{58} Profits were computed in accordance with the Income Tax rules but the Act provided certain liberal expenditure rules. Assesses could apply for the revision of assessment on the grounds that they (i) had to postpone their repairs and renewals in consequence of war; (ii) had suffered exceptional depreciation; or (iii) plant and machinery installed for war work could not be used after the war. The Act further provided that the super-tax under the super-tax Act, 1917 would also be leviable on those business profits which were chargeable to the Excess profits Duty Act, 1919. As originally envisaged, the Excess profits Duty Act, 1919 was repealed with effect from April 1, 1920.

With the outbreak of hostilities in Europe in 1939, which culminated into the Second World War, India was made a party to the war efforts of the United Kingdom. To mop up resources for the war, an Excess Profits Tax Bill was introduced on February 6, 1940. The Excess profits Tax Act, 1940 imposed a tax on excess business profits made after September 1, 1939\textsuperscript{59}. Profits for the purpose of tax was computed in accordance with the income-tax rules with certain adjustments; the more important ones were as follows: -

1. Carry–forward of unabsorbed depreciation and loss was not permitted;

\textsuperscript{58} The Gazette of India, part IV, March 22, (1919).
2. Loss, only of chargeable business, could be set-off during the year of occurrence;

3. Interest on borrowed funds, used for increasing the capital after the standard period, could not be deducted; and

4. Income from investments could not be added to the chargeable profit in the case of companies other than banking, insurance and investment companies.

The Excess profits Tax was abolished in respect of profits earned after March 31, 1946.

In the budget for 1947-48, a Business Profits Tax was introduced on any profits earned in the accounting period beginning on April 1, 1946. Thus the excess profits tax introduced since 1939 was continued without any break with the introduction of the Business Profits Tax Act, 1947. However, profits for the purpose under this Act was to be calculated in accordance with the income tax rules without any provision for allowing directors' remuneration in a director-controlled company or for setting off unabsorbed depreciation brought forward. The Business profits Tax was abolished with effect from the assessment year 1950-51. All the above Acts were basically wartime measures.

59. The Gazette of India, part IV, April 13, (1940)
60. The Gazette of India, part IV, April 5, (1941).
In 1963, a super Profits Tax was imposed on the corporate sector only. The Super Profits Tax Act, 1963 came into force with effect from April 1, 1963.\textsuperscript{61}

The Super Profits Tax was replaced by the companies (profits) Sur-tax Act, 1964 (hereinafter referred to as the Surtax Act) came into force with effect from 1\textsuperscript{st} April, 1964.

The Finance Minister, while introducing the super profits tax Act, 1963, made the following observation:

"In our system of corporate taxation, there is no correlation between the rate of tax and the percentage of profits. These shortcomings need to be remedied especially at the present juncture when the corporate sector like the rest of the community must bear its share of increased national responsibility. Instead of revising the present system, I propose to superimpose on it a super profit Tax. That tax will operate when the income of a company after deducting the income tax and super tax payable by its exceeds 6 percent of its capital and reserves except for such amounts of reserves which have been allowed as deduction in computing the total income for income-tax. The rate of tax will be 50 percent when that income is above 6 percent but not above 10 percent of the capital and 60 percent on income above 10 percent. It is hoped that this tax will act as a disincentive to excessive profits and will help to keep down the prices".

\textsuperscript{61} The Gazette of India, part II, section I, Extraordinary, No 14, May 6, (1963).
The surtax Act applies to corporate assesses other than those, which have no share capital. It extends to the whole of India. The tax is in addition to the income tax payable by company. The term 'company' for the purpose of this Act has the same meaning as it has under section 2(17) of the income-tax Act as section 2 (9) of the Act provides that words and expressions used in the Act but not defined in the income-tax Act, shall have the meanings given to them in that Act. Thus, the term 'company' will also include a foreign corporation which has been declared by the central Board of Direct Taxes to be a company under the Act Heckett Engineering company V CIT (1979) 130 ITR 417 (Patna).

Chargeable profits:

Surtax, as per section 4 of the Act, is charged in respect of so much of the chargeable profits of the previous year, or years, as the case may be, as exceed the statutory deduction at the rate, or rates, specified in the Third schedule to the Act, The term ‘chargeable profits’ has been defined in section 2(5) of the Act to mean total income an assessee computed under the income-tax Act 1961 for any previous year(s), as the case may be, and adjusted in accordance with the provisions of the first schedule to the Act. ‘Total income’ determined under the Income – tax Act, after allowing various exemptions, relief, deductions, etc., forms the starting point or base for determining the liability under the surtax Act.
The First schedule to the Surtax Act comprises of 3 rules. Rules 1 and 2 provide for certain deductions from the total income arrived at under the Income-tax Act. Rule 3 provides for some additions to be made to such income. Thus two-fold adjustments are necessary under the Surtax Act for determining the 'chargeable profit'. The total income as determined under the Income-tax Act is to be reduced by items mentioned in Rules 1 & 2 and is to be increased or adjusted upward by items mentioned in Rule 3.

Exclusion from the Total Income:

The amounts which are to be excluded from the total income under the Income-tax Act to arrive at the chargeable profits are:

ii) Income chargeable under the head 'capital gains' under the Income-tax Act.

iii) Any compensation or other under payment chargeable as business income under section 28 (ii) of the Income-tax Act;

iv) Profits and gains of life insurance business;

v) Income in the nature of ‘balancing’ charge assessable under section 42(2) of the Income-tax Act;

vi) Interest on Government securities which is ‘tax free’;
vii) An amount equal to 50 per cent of the sum with reference to which deduction is allowable to a company under the provisions of section 80 G of the Income-tax Act;

viii) Dividends from a domestic company;

ix) Royalties received from the Government or a local authority or any Indian concern. With effect from the assessment year 1981-82, net dividends / royalties after giving due effect of deduction under section 80 M / 80 MM are deductible vide Finance Act 1981.

x) Income by way of interest or fees for rendering technical services from the Government or a local authority or any Indian concern in the case of a foreign company (non-resident company) which has not made the prescribed arrangement for the declaration and payment of dividend within India.

xi) In the case of banking company:

a) any sum which during the previous year, is transferred by it to a ‘statutory reserve fund’ or deposited by it with the Reserve Bank;

b) any sum transferred during the previous year to any reserve in India including reserves which are not shown as such in the published balance sheet in so far as the sum transferred to such reserve is attributable to the income chargeable to tax under the Income-tax Act and has not been
allowed as a deduction in computing its taxable income and in so far as the aggregate of such sum does not exceed the highest of the aggregate of the sum, if any, so transferred during any one of the three years prior to the previous year, whichever is higher.

xii) The amount of any deduction from the Income-tax chargeable on the total income allowed under the Annual Finance Act in connection with export of any goods or merchandise out of India or the sale by a manufacturer of any articles to any person who exports them out of India (Rule I.).

(A) The amount of Income tax in respect of its total income under the provisions of the Income-tax Act after making allowance for any relief, rebate, or deduction to which the company may be entitled under the provisions of the said Act or under the Annual Finance Act, after excluding from it such amount:

a) the amount of income-tax payable by the company in respect of any income chargeable to tax as capital gains, any compensation chargeable as business income, profits of life insurance business, and inter-corporate dividends included in the total incomes;

b) the amount of tax payable by a company under section 104 and with reference to the relevant amount of distribution of dividends by it;
(B) The amount of tax actually paid by the company, which has been charged in a foreign country on any part of its total income included in the taxable income as computed under the Income-tax Act in accordance with the laws of the foreign country after allowance of every relief, provided the company produces evidence of such payment (Rule 2).

Additions

The amount arrived at after giving effect to rules 1 & 2 of the schedules is to be increased by any expenditure, incurred on account of commission, entertainment and advertisement to the extent such expenditure, in the opinion of the ITO, is not excessive having regard to the circumstances of the case. However, additions of this nature can be made only with the prior approval of the Inspecting Assistant commissioner of Income tax.

It may be stated in this context that prior to the assessment year 1977-78, the amount of any-interest payable on long-term borrowing was also to be disallowed and added back.

Statutory Deductions: Section 2(8)

Chargeable profits worked out in the above manner are to be taxed only to the extent as these exceed the ‘statutory deduction at the rate or rates specified in the Third schedule. ‘Statutory deduction’ as per section 2(8) of the Surtax Act
means an amount equal to 15 per cent of the capital employed (10 per cent up to
assessment year 1976-77 by the company as computed in accordance with the
provisions of the second schedule or Rs. 2,00,000 whichever is more. If the
previous year is longer or shorter than a period of 12 months, the amount of
statutory deduction is to be increased or decreased correspondingly.

Computation of Capital Employed:

The capital for the purpose of calculation of statutory deduction is to be
taken at the beginning of the previous year of the company. Where a company has
different pervious years for different sources of income, Computation of capital is
to be made with reference to the previous year, which commenced first under Rule
1, the capital is to be the aggregate of the following amounts:

i) Paid-up capital: If there is any share premium received in cash, that would
be added to the 'Paid-Up-Capital.' Paid-up capital comprises both of equity
and preference short capital.

ii) Development Rebate Reserve and Investment Allowance Reserve.

iii) Other reserve as reduced by the amounts credited to such reserves as have
been allowed as deduction in computing the income of the company. Reserve in
the nature of surplus, proposed additions to reserves and sinking fund appearing
under the head ‘Reserve and Surplus’ and also any item appearing under the head
‘current liabilities and provisions’ in the column relating to liability in the form of balance – sheet prescribed under the companies Act, 1956 are not regarded as reserves for the purposes of computation of capital employed.

Up to the year 1976 – 77 amount of debentures and long – term borrowings from central Government, Industrial Finance Corporation of India, Industrial credit and Investment Corporation of India or any other Financial Institutions notified by the central Government were also considered for working out the amount of capital employed. From the assessment year 1977 – 78, when the rate was raised from 10 to 15 percent, capital employed means owned capital of the company exclusive of borrowed funds, Likewise, interest paid on long term borrowings and debentures is also not added back in computing the changeable profit from this year.

Bonus shares issued during the previous year by utilization of the part of the accumulation in the general reserve are ignored for capital computation because capitalization of the general reserve implies mutually compensating re-adjustment of two elements, both forming part of the capital of the company and this does not result in any increase in the capital of the company for the purpose of surtax assessment.

Reserves

The interpretation of the term ‘Reserve’ is quite controversial. This term has not been defined in the income tax and the sur-tax acts. In the companies Act
1956, in one of the schedules, the term 'provision' and 'reserve' have been defined, but the definition of 'reserve' is merely a negative nature. According to William Pickles, 'Reserves' consist of appropriation from profits and other surpluses being amounts which are not designate to meet any liability, contingency, commitment or diminution in the value of assets known to exist at the date of the balance sheet. The supreme court of India, while considering comparable provisions of the second schedule to the Business profits Tax Act 1947 has defined reserve as "profits earned by a company not distributed as dividend to the shareholders and kept back by the directors for any purpose to which it may be put in future". [C.I.T. Vs. century spg. & mfg. company Ltd. (1968) 24 ITR 499].

There are many decisions on the question as to what is reserve and what is not. Thus, the amount standing to the credit of a proposed dividend account or dividend equalization reserve account has been considered as reserve C.I.T. Vs. Mafatlal Chandulal & co Ltd. (1977) 107 ITR 489 (Guj.), Addl. C.I.T. Vs. T. Mills Ltd. and Another (1977) 108 ITR 236 (mad); but the amount set apart to meet a present or known liability like 'taxation reserve' has been considered as a provision only 107 ITR 489 (supra); 114 ITR 439 (mad): 111 ITR 185 (cal) etc. Forfeited dividends have been held to be 'reserve' (orient paper Mills Ltd. Vs.C.I.T. (1978) 113 ITR 550 (cal); but a reserve for 'doubtful debt' which was not drawn upon and bad debts were in fact written off by debiting the profit and
loss account, has been held to be only a provision and hence was held to be not ineludible in the computation of capital under the schedule; C.I.T.Vs. Eyre smelting (P) Ltd. (1979) 118 ITR 857 (cal.). A mass of undistributed profits was held to be not reserve in the century Mill's case (supra)

Excess amount of depreciation reserve over the amount of depreciation allowed under the Income-tax Act has been held to constitute reserve for the purpose of capital computation C.I.T.Vs. India Leaf Tobacco Development co. Ltd. (1981) Co Taxman 275 (cal) similarly where amounts are set apart towards provision for staff gratuity, contingencies, freight rebate etc. in an ad hoc manner and there is no existing liability or possibility of its arising in future, the amount could be considered as reserve for capital computation purposes; C.I.T.Vs. Gokak Mills Ltd. (1982) 135 ITR 785 (Bombay).

An amount standing to the credit of initial depreciation reserve account where such depreciation had been allowed as deduction in computing the income of the company can not be treated as 'reserve' in computing its capital; MP sugar Mills Co. (P) Ltd. Vs.C.I.T. (1979) 120 ITR 348 (All).

Such instances can be multiplied. However, the issue to be decided is fundamental. As pointed out by the Supreme Court in C.I.T.Vs. standard Vacuum oil co (1966) 56 ITR 685 (SC), the name given to an account is immaterial. What is to be considered is its true nature.
Other Procedural Matters:

The administration and procedure for assessment and re-assessment, collection, appeal, revision and references etc., under the sur-tax Act are mostly, identical to those operative under the Income-tax Act and the Act is administered by the Income-tax authorities. Provisions relating to levy of interest, refund claims, forms for appeals, cross objections before the Income-tax Appellate Tribunal etc., for Income tax have been adopted for Sur-tax Act also.

Zero Tax Company:

It is an accepted canon of taxation to levy tax on the basis of ability to pay. However, exemptions and relief, particularly in the corporate sector, are so extensive that many flourishing companies with disposable commercial profits and declaring attractive dividends could substantially reduce their tax liability by availing of the incentives and the concessions, within the framework of the Income Tax Act, 1961.

As a sequel to the recommendations of the Public Accounts committee in their 143rd report (7th Lok Sabha), that the impact of various tax exemption granted, particularly to the corporate sector should be evaluated, and as a measure of equity a new chapter VIB\textsuperscript{62} was introduced by the Finance Act, 1983 with

effect From 1st April 1984 so as to compel the high profit earning companies, which reduce their tax liability to zero or national exchequer, by paying tax on at least 30 per cent of their profits. This provision was introduced in the form of sec 80-V V A. However, its implementation revealed that it was inadequate, ineffective and had several incongruities in it. Consequently, a new provision see 115 J was introduced in the Finance Act, 1987, with effect from assessment year 1988-89 for the levy of minimum tax on companies, (other than those generating power) which had disposable commercial or accounting profits, and yet were not paying tax or paying only nominal tax under the normal provisions of the Act.

The chief difference between see 80 VVA and sec 115 J was that while in the former most of the unadjusted deductions/ tax concessions could be carried forward to subsequent years, in the latter case the unavailed allowances/ tax incentives could not be carried forward to the following year. Further sec 115 J was based on book profits as computed under the companies Act, 1956 and it was to supersede all provisions of the Income Tax Act, wherever the taxable income was lower than 30 percent of the book profits. In contrast sec 80 VVA was based on pre-incentive total income as computed under the Income Tax Act, 1961, requiring the aggregate amount of deductions to be limited to 70 percent of the pre-incentive total income.
The Act also provides that the application of the special provision under sec 115 J of the Income Tax Act, 1961 would not affect carry forward of unabsorbed depreciation, unabsorbed investment allowance and unabsorbed business losses to the extent not set off. Under the Income Tax Act, 1961, with effect from the assessment year 1988-89 to 1990-91, the income chargeable to tax of any company other than a company engaged in the business of generation of electricity, whose total income as computed under the normal provision of the Act in respect of any previous year is less than 30 percent of it’s book profit, shall be deemed to be the amount equal to 30 percent of such book profit. For this purpose, book profit means the net profit shown in the profit and Loss account for the relevant previous year prepared in accordance with the provisions of the Companies Act, 1956, subject to certain addition/deletions as embodied under the Act under the normal provisions.

A review was conducted by the present researcher to evaluate, in general, the objectives set forth in the legislation for augmenting revenue from the corporate sector, particularly from the so called ‘Zero tax’ companies. An attempt was made to assess the degree of compliance by the corporate assesses with the law and procedural requirements and the manner of implementation of the scheme. A test checks of the companies for the assessment years 1988-89 to 1990-91 involving
application of section 115J (deleted with effect from Assessment year 1991-92) reveals that.

1. The provision was required to be invoked even in cases where computation of income under the normal provisions of the Act results in ‘Nil’ income or a loss and omission to invoke the provisions of Minimum tax resulted in short levy of tax.

2) The unwarranted application of special provisions led to underassessment of income involving under charge of tax.

3) In some cases, the net profit as per profit and Loss account was not increased by the amount of provisions for bad and doubtful debts, gratuity, estimated loss on slow/ non moving/ non usable stores, write back of depreciation, excess provision of earlier years, written back etc, resulting in undercharge of tax.

**Minimum Alternative Tax on companies:**

Minimum Alternative Tax (MAT) on companies was introduced by the Finance (No2) Act, 1996 ⁶³ with effect from 1st April 1997 with a view to ensure that companies with business profits do not regularly avoid paying tax. This was necessary due to rise in the number of zero tax companies in view of tax

⁶³. The Economic Times, Friday 1, March' 1997, Cal. P-XV.
preferences granted in the form of exemptions, deductions and high rate of depreciation.

The motivation behind the introduction of MAT is two-fold. One is to combat tax avoidance, the possibilities for which are a function of the existing design of the corporate income tax, and the loopholes in the name of growth or other incentives that get built into it over the years. The case for a minimum alternative tax is, however, based only partly on the difficulty of removing concessional provisions already enshrined in corporate tax legislation. The discontinuance of section 115 J was not a result of legal defect. Even if avoidance could be fully plugged, there still remains a need for an alternative means to combat the scope of evasion arising from information vacuum in tax administration. A minimum alternative tax does not eliminate avoidance or evasion altogether, but caps the advantage from such practices by placing a floor on tax payable. In so doing, it makes the corporate tax more equitable in its incidence.

After section 115 J of the Income Tax Act, 1961. The Finance (No. 2) Bill, 1996 of the Union Budget 1996-97, inserted a new section 115 JA\textsuperscript{64}. Sec 115 JA which deals with deemed income relating to certain companies, says that the total income, as computed under this Act in respect of any previous year relevant to the assessment year commencing on or after the 1\textsuperscript{st} day of April, 1997 is less than

\textsuperscript{64}. The Economic Times, Wednesday 24\textsuperscript{th} July' 1996 p – IV.
thirty per cent of its book profit, the total income of such assessee chargeable to tax for the relevant previous year shall be deemed to be an amount equal to thirty per cent of such book profit. Every assessee. Being a company shall, for the purposes of this section prepare its profit and loss account for the relevant previous year in accordance with the provisions of parts II and III of schedule VI to the companies Act, 1956.

The Finance Act, 1997., inserted a new section 115 JAA as regards tax credit in respect of tax paid on deemed income relating to certain companies under section 115JAA, where any amount of tax is paid under sub-section (1) of section 115 JA by an assessee being a company for any assessment year, then credit in respect of tax so paid shall be allowed to him in accordance with the provisions of this section.

Under Subsection (2) of see 115 JA, the tax credit to be allowed under sub-section (1) of section 115 JAA shall be the difference of the tax paid for any assessment year under sub-section (1 of section 115 JA) and the amount of tax payable by the assessee on his total income computed in accordance with the provisions of this Act. The Finance Act allowed to set off and carry forward MAT credit under section 115 JAA from the assessment year 1997-98. MAT paid in set off against tax payable in five subsequent years. However, this benefit will be

65. The Economic Times, Saturday 1st March 1997, p – IV.
available when tax payable at a rate more than 10.5 per cent of Book profit from assessment year 1998-99. The scheme provides only a carry forward of MAT credit, but no carry forward of MAT debit. In other words, if the book profits are low in initial years and higher in latter years, the MAT paid in subsequent years can not be used to set off tax paid in the initial years. Accounting for taxes on incomes (IAS12), carry forward of debit as well as credit balances of tax credits is prescribed, but section 115 JAA of the Income Tax Act does not permit carry forward of debit balance or loss. In case of merger and acquisition, shares of these combines are value at a premium. Similar is the case with the companies having accumulated MAT credit. Carried forward losses and depreciation become an asset to those entities having heavy profits against which depreciation and losses can be set off. With the relaxation available, it is hoped that the companies will be willing to pay up the minimum tax and not adopt ways and means to retain their coveted zero – tax status.

**Some Views Regarding the Sur-tax Levy:**

The basic criticism against Sur – tax is that it taxes efficiency in the sense that it has the effect of penalising the more efficient use of capital when the need of the hour is to maximise production. The Economic Administration Reforms
commission (popularly referred to as the Jha commission) has summed up the position regarding this tax in its report in the following words:

In our country, it is for the utmost importance that companies should try to maximise production out of the investments already made. To the extent, the production goes up, their profits are likely to rise. To levy a higher tax on such profits acts in the long run as disincentive. Levies on excess profits are ordinarily made during a war because in the conditions then generated, companies may make higher profits not by higher output, but by prices. It is significant that tax on excess profits was introduced in 1963 immediately after the Chinese aggression and to some extent was inspired by the precedents of legislation of World War II. However, as a long term measure, the problem of excess profits is dealt with by increasing excise duties on concerned products or also by administered prices as are already in vogue in quite a few cases rather than by raising the levy on corporation as a whole.

Various expert committees have examined the desirability of a tax like 'Sur-tax' of the corporate sector. Both the Bhothalingam committee of 1967 and the Wanchoo committee of 1971 which had occasion to analyse the operation of the Sur-tax on corporate profits introduced in India in the year 1964, after careful consideration, come to the conclusion that such a tax should be abolished forth

with. The observation of shri Bhootalingam while recommending the abolition of Sur – tax are as under: -

The sur-tax in effect introduces the progressive principle which, while eminently appropriate in the case of individuals as reflecting both capacity to pay and social justice, is completely inappropriate in the case of impersonal organisations. The base of the sur-tax corresponds pretty closely to capital effectively employed. A higher discriminatory rate of taxation, therefore, penalizes the more effective use of capital. 68

The Wanchoo committee, on the other hand, has suggested the introduction of ‘capital levy’ on companies in substitution of the companies (profits) Sur – tax. A tax on capital has been suggested for rationalizing the scheme of company taxation and avoidance of wealth-tax through the medium of closely held companies. The capital levy has been suggested for both owned and borrowed capital and would thus act as a check on avoidable capital expenditure and borrowings. It would also discourage unnecessarily large inventories and would be neutral between risk capital and borrowed funds. In order to ensure that this levy does not deter the formation of new industrial companies, the committee recommended a 5-year holiday from levy for such companies from the date of their incorporation. The rate recommended was a flat rate of 1 percent on owned and

borrowed capital and reserve other than reserve for specific contingent liabilities. The borrowed capital has to be worked out, as per the committee's recommendation, by multiplying the net interest paid by a figure of eight. The Government has not accepted this recommendation of the committee.

The Choksi committee did not favour abolition of and its merger with Income-tax. It has recommended measures for reducing its impact on more efficient companies. It has made elaborate recommendations in chapter 15 its final report regarding this tax. Its major recommendations are:

a) The two terms 'reserve' and 'provision' should be defined in the Sur-tax Act.

b) The deficiency in chargeable profits with reference to the standard deduction relating to a year should be allowed to be carried forward and set-off in the following years before the determination of the chargeable profits which attracts Sur-tax liabilities.

c) The statutory deduction be increased from 15 percent to 20 percent of the capital.

d) Sur-tax should be levied at the flat rate of 40 percent.

The Jha committee has also recommended the abolition of this tax. Thus the weight of the opinion of the export committees is in favour of its abolition.
In view of the substantial amount of collection from Sur-tax by the Government, it is a matter of policy for the Government to decide whether it should lose a good source of revenue, which has been increasing year after year, on some doctrinal and academic considerations.

**Effect of Taxes on Selecting the Legal Form of Organisation:**

The corporate form of organization is the only form, which makes possible the accumulation of large sums of capital to establish large-scale business enterprises. There are, however, thousands of business concerns which could raise sufficient capital while operating as a proprietorship, a partnership or a corporation; when this is true, Management should consider factors other than the ability to raise capital when deciding as to which type of organization will serve its purpose best.

Taxation is important financial consideration, which influences the choice of forms of business organization because of differential tax treatment of income of different forms of organisation. A comparison of the different forms of organization reveals that a business organized as a proprietorship does not pay an income tax as a business unit; the proprietor pays an income tax on all of his income from the business whether it is left in the business, paid out of salaries, or withdrawn as profits. The important point here is that the proprietor is taxed at
rates, which are applicable to the individual receiving the income. In the case of a partnership, each partner pays an income tax as an individual on his share of profits whether it is withdrawn or not.

A Corporation, on the other hand, is a separate taxable entity, which means that one income tax is levied at the corporate level and another on the profits, which are received by the owners (shareholders) in the form of dividends. The double tax on the corporate income does not mean that the tax rates in the aggregate will be higher than those paid by a proprietor or a partner.

The determination of the legal form of organization is influenced by both financial and non-financial considerations. However, financial considerations play an important role in the choice of a form of organization. The important financial considerations are: 1) Ability to raise funds; 2) Limited liability; 3) Present and future tax rates 4) Salaries paid to the owners of the business; 5) Capital structure; 6) Dividend policy; 7) Financial requirements of the firm; 8) Deferred compensation plans; 9) Fringe benefits; and 10) Outside sources of the income of the owners of the business.

The corporate form of organization results in a higher tax than either a partnership or proprietorship when the entire profits are distributed currently and a part of these profits are paid out as dividends. However, if the income is deferred,
leveled out or taken out at the capital gains rate, the taxes of the corporate form may be less than those of partnerships or proprietorships.

**Effect of Taxes on Dividend Policies:**

The corporate management is responsible to take important policy decision in respect of the distribution of corporate profits. Although the management is influenced by number of factors while formulating the firm’s pay out policies, the only one considered here is taxation. This factor is of more importance because corporate income is subject to taxation at both the corporate and the individual level. Double taxation does not mean that the tax rates on corporate taxable income will necessarily be higher than if the business were operated as a partnership or proprietorship. However, when the total profits of a corporation are distributed currently in the form of dividends, the tax bill of the corporate form of organisation results in a higher tax than would have resulted from a partnership or proprietorship.

While the dividend policy is influenced by the tax liability of the shareholders, the companies may not choose to declare high dividends even when the level of profits warrants such declaration, because that will lead to the payment of taxes at a higher rate by the shareholders. Thus, the internal accumulation of funds is also effected indirectly. This influence is transmitted via dividend policy.
To quote Md. Mohsin “It is true that whether to retain or distribute the profits of the corporation is one of the most important question of financial policy over which taxation may not have any direct bearing. But taxation can influence the judgement at least in two ways. As custodian of the corporate enterprise, the management has to safeguard the interest of the company and as trustees they have to look after the interest of the shareholder”\(^{69}\). The study by Mohsin reveals that the implication of increasing tax provision has fallen mainly on retained earnings. Irrespective of the fluctuations in the annul growth of profit after tax, the rate of dividend was more or less fixed throughout the period of study. He, therefore, blames the corporate management in pursuing a stable dividend policy, which has erased the companies’ internal savings. He opined that in a less developed economy where the corporate sector is poised for growth, company management would follow a conservative dividend policy and re-invest a major part of their earnings for growth.\(^{70}\)

The size of the companies also influences the decision of the management regarding the Quantum of the profits to be retained. Although the desire to put a considerable part of income to reserve is a dominating consideration in the conduct of small companies, it can not be denied that this motive is also to be found in the


\(^{70}\) Ibid. – pp-45-46.
large companies because their share must stand at a higher quotation than the paid-up capital, if they are to be able to issue new shares when this is felt to be necessary. Furthermore, in large companies which have very many shareholders and where shares are generally quoted on the stock Exchange, there is another requirement: their dividend must be kept stable. So the management puts into reserve a substantial proportion of profits when profits are large so as to cover times when profits are small. Stable dividends enhance the company’s credit and make it appear that the company’s business is going on normally and that the shares issued on the strength of profits ploughed back are not liable to wide price fluctuations. A stable dividend ensures that shares can be placed with investors and, at the same time, preserves them from the uncertainty of speculation.

There have been a number of studies of the impact of changing rates of tax or tax systems on the dividend policies. The general conclusion from Feldstein’s\textsuperscript{71} study is that the use of differential tax rates on dividends and retained earnings has significant effects on the level of dividends, and thus on corporate savings. However, in a comment on Feldstein’s article, King\textsuperscript{72} argues that though differential tax rates are effective in raising the level of retained earnings, their impact is much less than Feldstein’s results would imply. The bias, King argues,

arises because of Feldstein's miss pacification of the effect of tax changes on the level of profits. His introduction of the ratio of maximum net profits to gross profits into the model to take care of this effect ignores the relationship between the level of net profits and dividends arising from the differential tax treatment.

Among other leading works on dividend behaviour, Dobrolovsky73 made a close statistical study of companies and partnerships with share capital over the period 1915-1943. After rejecting the fairly commonly held opinion that companies divide their trading profit into two equal parts (one for distribution, the other to be put to reserve), he observes that the companies studied do not put profits to reserve if the trading profits is less than approximately 5 per cent of their net assets. If the profits fall below this figure, the company tends to distribute the profits put to reserve, while in the contrary case the profits put to reserve increase as trading profits go up. Translating this into current economic terminology, it may be said that the companies have an average propensity to save, which varies in relation to the amount of trading profit.

Considering these studies as a whole it may be concluded that the management of a corporation can reduce the total amount of its taxes through a dividend policy to a point where it is less than what it would be if the business

were operated either as a partnership or proprietorship. If Corporate dividend policy is such that income can be taken out of the business by stockholders through the capital gains rout (sale or redemption of stock) then the total tax bill is less than what it would be if the income were paid out currently in the form of dividends. To accomplish this, the corporation should plough its income back into the business rather than pay out dividends as they are earned.

Effect Of Taxes on Capital Procurement Policies:

The effects of taxation are so widespread and complicated that it is hardly possible to take a business decision without regarding the tax implications involved. The taxes may not only affect the volume and pattern of investment, but may also affect the method of financing.74 So long as the current method of corporate tax base computation prevails, debt funds will remain the cheapest up to certain limits. Under a corporation tax of the Indian Variety, interest payment to bondholders are deductible for income tax purposes, whereas no deduction is allowed for dividends. Therefore, financing with debt instruments is cheaper than with equity instruments. Thus, the effect of tax provides an incentive to bond issues as against stock floatation. Critics of the tax argue that increased reliance on

74. See, D. T. Smith, Effects of Taxation: Corporate Financial Policy, Harvard University Graduate Scholl of Business Administration, BOSTON, (1952). (Where more extensive discussion of this problem is to be found).
bond issues might lift corporate fixed charges to a level, which might cause financial stress and reserve depletion in a period of business slackness.

Because the total cost of financing with debt capital is less than the cost of financing with equity capital, as pointed out above, there is no argument that taxation does not have an effect upon corporate financial stricture. However, it may be possible that methods of financing in corporate sector is also related to several other factors determining the capital structure where the corporate tax is less significant than commonly supposed. Generally, when the corporation has the financial strength and recognition to have some choice on its means of financing, it may well ponder the pros and cons of both shares and debentures. It is only at the advanced stage of development that the capital structure of a company becomes sensitive of a company becomes sensitive to taxes, only established companies issue securities bearing fixed obligations to gain considerable economies effected in the cost of money to earn additional return for the owners of the business. The opportunity for gain is suggested by the term ‘trading on the equity’ However, in most cases corporate management will not compromise sound financing principles in order to take advantage of saving resulting from deducting interest charges. This is to say that management would not incur the disadvantages of trading too heavily on its equity in order to reap the benefits of cheaper financing costs.
This is particularly true in organizations whose financial executives are well grounded in financial principles and practices; however, there are many smaller corporations who do not have personnel adequately trained in financial planning, and as a result of insufficient knowledge, they may employ too much debt capital in their financial structure. It can not be emphasized too strongly that the correct proportion of debt to equity capital in the financial structure should not be sacrificed in order to secure short-term tax gains. On the other hand, over conservatism on the part of management often results in excessive cost of financing because the proper ratio between debt and equity capital is not maintained. It may be generally stated, then, that debt instruments should be used in the capital structure only so long as the correct balance between debt and equity capital is maintained.

Effect Of Taxes on Leasing:

A lease is a contract whereby the owner of an asset (the lessor) grants to another party (the lessee) the exclusive right to use the asset usually for an agreed period of time in return for the payment of rent. Recent decades have seen an enormous growth in the leasing of business assets. An obvious advantage to the lessee is the use of an asset without having to buy it.
Leasing equipment affords an advantage from the viewpoint of taxation. The principal tax advantage lies in the fact that through adjusting the annual rentals, the actual cost of the plant or equipment can be realistically charged against current earnings. When plant or equipment is financed out of equity funds, only the depreciation charges can be claimed as expenses, and it is well known fact that it is not always possible to compute depreciation charges accurately, with the result that current income is distorted.

If proper depreciation is not charged off, profits may be either overstated or understated. If the plant and equipment are financed out of borrowed funds, only the interest on the amount borrowed is charged as an expense, and of course, the depreciation is charged against income. But since amortization charges and annual rent payments are deductible as operating expenses, the firm’s true income is more likely to be accurately reported, with the result that the firm’s tax bill will more nearly coincide with its current income.

There are definite tax advantages to the firm that employs the sale and leaseback technique. Take, for example, a firm that acquired a property when the price of construction and the value of real estate were below the existing market value. In this case, the property is valued at a low price and the amount which is deductible for depreciation is for below what depreciation would be if the property were valued at the higher market value. As a result, replacement cost will greatly
ill exceed the depreciation charges during the life of the property. On the other hand, under a sale and leaseback arrangement, a firm sells an asset to another party, and this party leases it back to the firm. Thus, under this arrangement a firm would not only be able to get the approximate market value of the assets but also would be able to deduct from current income an amount more commensurate with the true depreciation charges.

In recent years, a special form of leasing has become popular in the financing of assets requiring large capital outlays. There are three parties involved in it which is called leveraged leasing: (1) the lessee, (2) the lessor, or equity participant and (3) the lender. Under this arrangement the firm (Lessee) would enjoy all the benefits like any other types of lease. However, the firm (Lessor) acquires the asset in keeping with the terms of the lease arrangement and finances the acquisition in part by an equity investment and the other part is provided by the lender. The loan is usually secured by a mortgage on the asset, as well as by the assignment of the lease and lease payments. As owner of the asset, the firm who is also the borrower is entitled to deduct all depreciation charges associated with the asset. The cash flow pattern for the lessor typically involves (1) a cash outflow at the time the asset is acquired, which represents its equity participation; (2) a period of cash inflows represented by lease payments and tax benefits, less payments on
the debt; and (3) If there is any residual value at the end of the lease period, this of course represents a cash inflow to the firm (Lessor).

Although there are certain tax advantages associated with all these above techniques there are also some disadvantages of these methods; therefore, financial executives should weigh all factors before a decision is made to resort to the above methods.

**Effect of Taxes on Evaluation Policies:**

The size of the tax bill is definitely affected by the criterion, which is followed in valuing inventories. The amount of tax payable is influenced by the profits of the company, which in turn is affected by the methods employed in valuing inventories. The two most common methods of valuing inventories are (1) Cost and (2) Market cost, whichever is lower. A new firm may select either method, but once a selection is made, no change can be made without the permission of the commissioner of Income-Tax. If the primary reason for a request to change is to reduce the tax bill, permission will be denied. Therefore, careful consideration should be given in selecting the method of valuing inventories.

In many cases companies which seek to conceal their profits, either in order to follow a cautious reserve policy or to reduce their tax liability, tend to value
their stock as low as possible. Thus there are two contradictory lines of action, one by the management who desires freedom of choice to manipulate its own nominal profit as best it can by this means, and the other by the tax authorities who tend to restrict this freedom of choice, either to prevent tax evasion or to be able to tax anything which looks like profit even if it is purely nominal. Particularly in concerns where working capital is comparatively large in relation to fixed capital, even a modest upward or downward valuation of closing inventories, leads to substantial accounting profits or losses. In view of the fact that the overall stock has not changed, these profits or losses are not yet realised and remain merely potential and therefore subject to the risk of subsequent changes in price before the goods are sold. However, under the existing rules of the Income-Tax Act, once a company selects a particular method of valuing inventories can not change to another method without the permission of the commissioner of Income-Tax. So a company today can not adopt different methods for valuing inventories to suit its own requirements of tax advantage.

The best known methods of evaluating inventories are LIFO (Last in First out) and (2) FIFO (First in First out). As a result of fluctuating prices, certain tax advantages may be gained by using LIFO Method of computing the value of inventories. Under LIFO method the inventories are valued at the most remote cost. LIFO method assumes that the first goods or products to be sold are the once
which came in last. In essence, this method comes close to valuation at fixed values and amounts to a sufficiently flexible compromise, so far as one has in mind a standing reserve whose value has no effect upon income, which is determined solely by variation in quantity.

Variations in price, because they synchronise with the valuation, have a very slight influence since current prices are balanced by costs, which are as nearly as possible the current costs. In the extreme case, where sales in one year are exactly balanced by equivalent purchases, the cost of stocks does not come into the calculation of income and therefore has no influence whatever on the computation of income. This method, therefore, succeeds in neutralising price variations in a satisfactory manner. A firm may employ this method with the approval of the commissioner; however, once it is adopted it must be continued unless the commissioner requires the firm to change to another method or the firm petitions and receives approval to change the method. Under LIFO method the inventories on hand are valued at the most recent cost. In this method, the management of the firm starts on the assumption that the firm will sell goods or products from inventories in the chronological order in which they were acquired; the first goods to be sold are the ones, which have been longest in inventories. The profit is therefore arrived at by the difference between the selling price and the earliest cost. It is obvious that this system is extremely sensitive in computing income in relation
to variations in the market price as soon as the two terms in the comparison are separated as for as they can be (purchase price going back a long way compared with current selling price). This system unduly exaggerates the effect of price variation on income in a period of rising prices, whereas in a period of falling prices it artificially diminishes income by taking unreal losses into account. LIFO shows smaller profits during periods of rising prices, thus reducing the size of the corporate tax bill. It should be pointed out, however, that when prices are falling the tax bill would be larger since profits are larger.

The example illustrated in the Table 3.1 depicts the effects which LIFO and FIFO have on firm’s profits. In case of FIFO the firm’s gross profit is Rs. 2,5000, whereas profits under the LIFO method amount to only Rs. 15,000. That is the firm using FIFO will pay taxes on Rs. 7500 more than the firm using LIFO.
Table - 3.1

Effects on Profits: LIFO and FIFO Methods of Evaluating Inventory

<table>
<thead>
<tr>
<th></th>
<th>FIFO</th>
<th>LIFO</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales; 15,000 units @ Rs. 5.00</td>
<td>Rs.75,000</td>
<td>Rs.75,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Opening inventory</td>
<td>Rs.12,500</td>
<td>Rs.12,500</td>
</tr>
<tr>
<td>(5000 @ Rs.2.50)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Purchases</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(15000 @ Rs.4.00)</td>
<td>Rs.60,000</td>
<td>Rs.60,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less closing inventory</td>
<td></td>
<td></td>
</tr>
<tr>
<td>FIFO (5000 @ 4.00)</td>
<td>Rs.20,000</td>
<td>Rs.12,500</td>
</tr>
<tr>
<td>LIFO (5000 @ 2.50)</td>
<td>Rs.52,500</td>
<td>Rs.60,000</td>
</tr>
<tr>
<td>Gross profit on sales:</td>
<td>Rs.22,500</td>
<td>Rs.15,000</td>
</tr>
</tbody>
</table>

Business derives the greatest benefit by using LIFO when 1) inventories are large in proportion to assets and sales, 2) production periods are of considerable length, and 3) goods included in the inventory are subject to wide price fluctuations.

Corporate Taxation and Industrial Growth: ✓

Taxation is an important instrument not only for allocation of resources and distribution of incomes, but also in promoting capital formation and in curbing inflation. It is widely believed that corporation tax can influence the pace of
industrial growth. The most important objective of all developing countries is attainment of rapid economic development. Industrialisation is regarded as a tool of economic development. In most of the primitive economies, the desire to manufacturing industry manifests specially in the desire for national prestige, which an industrial economy could give over fellow primary producers. This aspect is in addition to the three customary objects of industrialisation policy—to provide work for growing population, to raise the standard of living and to improve balance of payment situations.\textsuperscript{75} It is further argued that industrialization brings in its wake 'inventiveness', a modern outlook, the environment for rapid technological progress—indeed, the whole complex of industrial civilization which is necessary for a progressive nation\textsuperscript{76}.

Industrial growth thus can be an aspect of economic growth and the structural transformation of the economy.\textsuperscript{77} Industrial growth, as indeed all economic growth, depends upon certain pre-conditions whose fulfillment in varying degrees dictates the pace and pattern of industrial expansion.\textsuperscript{78} As industrial growth is a complex phenomenon, factors contributing to the infrastructure can be as wide as (i) economic: Means of transport and

communication, power, technical skills, banking and financial organisation, etc., or
(ii) non-economic; stable government, people’s psychology towards development,
social and religious, etc. By definition, all developing countries share the
problem of accelerating the pace of their growth processes, and economic growth
being a conglomerate of many dimensions can not be measured precisely either by
a single variable or by a simple combinations of variables. To further the pace of
industrial growth, a tax system besides aiming at transfer of resources form private
hands to public exchequer should incorporate a scheme of incentives aimed at
promoting directly an increase in saving and investment of the corporate sector.
The factors which generally determine the pace of industrial growth in a country
are: - i) Saving; ii) Investment; iii) Technology; iv) Labor; v) Resources, etc.
corporation tax is yet another factor affecting growth, though it can never be
considered in isolation from the general tax system. However, a close correlation
exists between corporation tax and industrial growth in that a growth-oriented tax
system would reward efficient enterprise by leaving ample internal resources for
financing expansion. A restrictive tax policy, on the other hand, would denude
industry of valuable funds, sap confidence in the industrial outlook and even defeat

79. United Nations: A study of Industrial growth, Department of Economics and social Affairs,
the government's efforts to get sufficient revenue. This demands an evaluation of the role of corporation tax in the light of various economic effects that it may have and the complaints of its drastic effects, as sometimes claimed.

**Effect Of Corporation Tax On Saving:**

Corporation tax may affect a company's capacity and desire to save. Saving is positively related to income function and possibly to the return to savings, i.e., \( \frac{ds}{dy} = +ve \) where, \( ds = \) additional saving, \( dy = \) additional income. Obviously, the capacity of corporations to save is reduced when their net profits are reduced by heavy taxation. This is so because the corporate saving usually comes from high and middle income groups, the stockholders. Taxes, thus, will have a bearing upon the ability and willingness of savers to employ their funds in business ventures. As Mr. Bangs puts it, "The more onerously these taxes bear on business income the less, broadly speaking, will be the inducement to employ funds in business pursuits." The argument that saving is affected by the corporation tax, is based on two counts; firstly, a large portion of corporate profits is retained and not distributed; taxes will naturally deprive corporations of the resources for expansion, secondly, the distributed profits go mostly to high income brackets who

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save and not consume the disposable income.\textsuperscript{83} Therefore, the effects of taxation upon the capacity of the corporations to save are certain, at least in direction, though the magnitude, however, is not certain. \textsuperscript{84} An attempt to examine the ‘magnitude’ was undertaken by Dr. Goode in the United States who found that in 1941, some 50 to 65 per cent of the tax was collected at the cost of net savings which would have otherwise been saved by corporation. \textsuperscript{85} In the case of the corporate sector in India, for example, it is estimated that out of every one thousand rupees of corporate profit, a major savings, the Government gets Rs.780- (Rs.527 as excise duty, Rs.135 as sales tax and Rs.118 as corporation tax). \textsuperscript{86} It suggests that the percentage of corporation tax is high as \( \frac{85 \times 118}{100} \) against the saving of Rs.85 (assuming the dividends declared at 15 per cent). Thus, a high corporation tax rate affects savings adversely.

In appraising the impact of corporation tax on saving, Dr. Goode suggests “to estimate its effect on dividend payments and retained profits or net savings of corporations.” \textsuperscript{87} But we know that dividend policy is only one of the determinants

\begin{flushleft}
\textsuperscript{87} Goode, Richard, (1951), op. cit. P-99
\end{flushleft}
of corporate saving and if corporation virtually compels the stockholders to save by adding to the reserves, there may not be discouraging effect on corporate saving. Though theoretically, this possibility may not be ruled out, it is not the usual case, particularly in long run, because a satisfactory rate of return must be provided to save otherwise ‘corporate enterprise will wither and die’.  

In examining the role of corporation tax on saving, we observe that hike in government expenditure leads to imposition of additional tax on corporate entities and thereby reducing corporate saving. Generalisation of the adverse effects of corporate taxation needs to pronounce a priori whether government’s expenditure is productive or not. For example, a productive expenditure by the government would widen the opportunities for business in the shape of increased sale and thereby there may be more income to save. Conversely, unproductive government expenditure will narrow the opportunity by profligate outlays and restrictive policies, causing dampening effect on willingness to save. However, this is a fertile ground for empirical testing whether government expenditure has been productive or not. So far as corporate saving in India is concerned, the only reliable study of the magnitude of saving is made by the Reserve Bank of India, but it fails to

89. Houston, G. Sidney., 'Taxation and Corporate Enterprise' in Annals, Vol. 266, p-93.
pronounce the productivity or otherwise of public expenditure. In India the volume of corporate saving has been manifested in the following table 3.2.

**TABLE 3.2**

<table>
<thead>
<tr>
<th>Financial year (1)</th>
<th>Corporate saving (Rupees in crores at current prices) (2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1970 - 71</td>
<td>227.0 (0.6)</td>
</tr>
<tr>
<td>1971 - 72</td>
<td>175.0 (0.5)</td>
</tr>
<tr>
<td>1972 - 73</td>
<td>188.0 (0.5)</td>
</tr>
<tr>
<td>1973 - 74</td>
<td>381.0 (0.7)</td>
</tr>
<tr>
<td>1974 - 75</td>
<td>593.0 (0.9)</td>
</tr>
<tr>
<td>1975 - 76</td>
<td>188.0 (0.3)</td>
</tr>
<tr>
<td>1976 - 77</td>
<td>226.0 (0.3)</td>
</tr>
<tr>
<td>1977 - 78</td>
<td>283.0 (0.3)</td>
</tr>
<tr>
<td>1978 - 79</td>
<td>301.0 (0.3)</td>
</tr>
<tr>
<td>1979 - 80</td>
<td>737.0 (0.7)</td>
</tr>
<tr>
<td>1980 - 81</td>
<td>891.0 (0.7)</td>
</tr>
<tr>
<td>1981 - 82</td>
<td>792.0 (0.6)</td>
</tr>
<tr>
<td>1982 - 83</td>
<td>816.0 (0.5)</td>
</tr>
<tr>
<td>1983 - 84</td>
<td>504.0 (0.3)</td>
</tr>
<tr>
<td>1984 - 85</td>
<td>874.0 (0.5)</td>
</tr>
<tr>
<td>1985 - 86</td>
<td>1348.0 (0.6)</td>
</tr>
<tr>
<td>1986 - 87</td>
<td>1242.0 (0.5)</td>
</tr>
<tr>
<td>1987 - 88*</td>
<td>(- ) 312.0 (-0.1)</td>
</tr>
<tr>
<td>1988 - 89*</td>
<td>1284.0 (0.4)</td>
</tr>
<tr>
<td>1989 - 90*</td>
<td>3230.0 (0.9)</td>
</tr>
<tr>
<td>1990 - 91*</td>
<td>5173.0 (1.2)</td>
</tr>
<tr>
<td>1991 - 92*</td>
<td>5427.0 (1.1)</td>
</tr>
<tr>
<td>1992 - 93*</td>
<td>7426.0 (1.4)</td>
</tr>
<tr>
<td>1993 - 94**</td>
<td>9854.0 (1.6)</td>
</tr>
</tbody>
</table>

**NOTE:** - * Provisional   ** Tentative
Table 3.2 reveals that corporate saving has remained within one per cent of the NNP (Net National product) during 1970-71 to 1989-90. However, it has increased to more than one per cent of the NNP during the period from 1990-91 to 1993-94.\(^\text{\textsuperscript{*}}\) The magnitude of the corporate saving no doubt has increased from RS 227 crores in 1970-71 to RS 9854 crores in 1993-94 but the growth of it does not exhibit any definite trend. In 1987-88, it has fallen sharply to RS-312 crores. However, since 1988-89, the corporate saving in India has shown an upward trend. The data, however, do not suggest that the high rate of corporate tax has been responsible for the erratic behaviour in corporate saving or whether public expenditure has been unproductive.

An examination of the effect of corporation tax on saving is generally suggested by examining its effect on ‘incentive to work’ also. It is argued that corporation tax, by its dampening effect on saving, reduces corporation’s incentive to work. When a high rate of taxation denudes corporations of resources for business, they do not feel encouraged to work harder for more profit or to have a stage of pre-tax profit. An empirical study by Mr. Kimmel was undertaken to examine this issue. One thousand Manufacturing industries were asked in the United States whether high tax rate affected their incentive to work. The majority

\(^{*}\) The reason for such increase in corporate saving May be attributed to the entry of Multi-national companies into India following liberalisation and globalisation, abolition of license & permit raj, simplification of tax laws in association with gradual sliding tax rate.
of them (95%) replied in affirmative.\textsuperscript{90} Later studied on this subject, however, do not support these findings.\textsuperscript{91} It is argued against Mr. Kimmel's hypothesis, that executives of corporations are concerned more with their profitable expansion than tax consideration and therefore, any rate of tax can be imposed without affecting a corporation's efficiency.\textsuperscript{92} A similar study by Harvard school revealed non-tax considerations as more significant than tax consideration, "taxes are more likely to determine how a thing is done than they are to determine what or whether an action is taken".\textsuperscript{93} In other words, incentives that lead people to undertake economic activity, very widely. Therefore, Messrs Butters and Lintner rightly say: "By disposition, these men are usually aggressive, imaginative, venturesome, and confident of their ability to succeed..... They want to be their own bosses, and will start their own business even though the opportunities for profit objectively considered, are not good.\textsuperscript{94} It is argued that non-financial incentives typically outweigh financial incentives in matters of basic decisions of the business and the habit of saving has been so ingrained in most individuals in middle and upper-


income groups that it has survived severe tax burden in the past. Moreover, the most recent empirical studies by Mr. Godfrey, Mr. Stern, and Mr. Hollister suggest that the effects of income taxation have minor effects on work efforts.

The foregoing discussions suggest that taxation affects savings but not to the extent often alleged as impairing the incentives to work and to save. However, any generalisation will be risky if only because all the countries of the world may not survive severe tax burden equally due to their inherent tax structure and fiscal policy. Empirical studies also have their limitations for obvious reasons and therefore, these exist scope for future research.

Effects of Corporation Tax on Investment:

Investment is one of the major determinants in undertaking any business enterprise. Investment is an act of parting with money for a specified period to acquire capital goods. Investment, when it is taken to mean the production of capital, has a two-fold role to perform in an economy. In the first place, investment helps acquire a variety and number of equipment and, secondly, it offsets saving.

an act of not spending over consumption. Saving is important for investment but it does not automatically enter into investment. An increase in saving will result into an increased investment only when savers themselves, or corporations, or intermediaries decide to invest (to buy capital goods). This investment is regarded as a highly strategic variable in the business cycle, with change in the level of investment being held primarily accountable for cyclical variations and employment.\footnote{99}

The major criticism advanced against the corporation tax has been that such a tax will have an adverse effect upon the volume of investment. Because, such a tax can influence the volume of investment by affecting corporation's incentive to invest in new venture, by reducing the supply of necessary funds both from internal and external sources, particularly when the corporation badly needs it for expansion. It is argued that a high tax rate, by reducing the prospective profits, tends to discourage investment, especially in ventures with a high 'risk' factor. It can inhibit risk taking because the tax takes away from 'successful outcome without necessarily offering relief for an unsuccessful outcome.'\footnote{100} Thus, corporation tax introduces a bias into any probability distribution of expected incomes, which makes a project less acceptable to investment decision-makers, resulting in substantial impairment to business. It becomes more pertinent than not

in countries where, in addition to uncertainty about the technical and commercial outcomes, these may be doubts about political stability. Investors must get a certain minimum return for their risks and efforts in business; a high corporate tax rate just shuts off large volume of investment. Lady Hicks in this connection observes that to tax companies at a higher rate merely because they are successful is "to impose a direct brake on efficiency and enterprise...(and) unfair on their poor shareholders." In fact, a company whose returns on capital are very low will have to face the problem of attracting new funds from the capital market. As Britain's former prime minister Mr. Edward Heath puts it, we would then have the survival of the fittest (most efficient) whereas now we have the survival of the fittest (most resourceful).

However investment is a complex phenomenon and unlike 'classical economists' basic propositions that saving equal's investment. It has now increasingly been recognised as an independent variable. For example a large volume of savings will not come forth, if investors are Unwilling to invest (saving here, is greater than investment). On the contrary, if investors are willing to invest even if there is low level of saving, they can bank upon bank credit or idle funds to

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101. Ibid. p-70.
invest in projects (investment here is greater than saving). This explains the
dichotomy as to how firms do not expand for want of investment funds even
though savings in the aggregative are excessive.\(^{104}\)

The foregoing discussion shows the direct effect of the corporation tax on
investment. However, Richard Goode has pointed out that there may be an indirect
effect of such a tax on investment. He suggests to examine its effect on
‘consumption’ (though it is not generally seen) when he says, “Taxes that reduce
consumption also restrict investment by narrowing the market......the tax is an
additional indirect or induced deterrent to investment.”\(^{105}\) Dr. Goode’s argument
is based on the fact that the profitability of investment depends, among other
factors, on the extent of market and the demand for investment goods, which in
turn, is derived from consumer goods corporation tax on investment will thus
reduce consumption. This leads to infer that ‘corporate tax impairs investment
incentives somewhat, reduces the level of retained corporate profits substantially
and lowers corporate abilities to acquire capital assets through the sale of new
shares of stock’.\(^{106}\) But this hypothesis needs to be tested by empirical studies
since it involves business management decisions which typically attach greater
significance to non tax considerations than to tax consideration. Whether

\(^{105}\) Goode, Richard,. (1951) op. cit. P-142.
\(^{106}\) Rolph, Earl R. and Break, George F., Public Finance, The Ronald Press Company, New York,
corporation tax impairs a business or not will depend upon a variety of factors such as the incentive devices offered in the tax laws, the tax structure, subjective reactions of investors, prevailing state of optimism or pessimism and perhaps upon political pique and hence, nothing can be said precisely a priori. However, corporation tax is bound to change the odds for a new enterprise and even a well-established one, though these are remote chances in the latter case. The latter may not be adversely affected so long as the tax provision allows losses to be 'carried forward' or 'carried back'. As a general rule, the more the low permits such a provision, the less likely the chances are of adverse effects upon well established corporations.

On the basis of the above discussion, it may be concluded in brief that, present knowledge is insufficient to give precise answer to the question whether a high tax rate affects investment and there is a scope for further research. Sweeping generalisations by businessmen and other on the adverse effects of taxation are mere assertions and do not stand firm on empirical tests.

Effects of Corporation Tax on Technology:

It hardly needs to be appreciated that the viability and dynamism of industry is governed by technology, which is society's pool of knowledge
regarding the industrial arts. The development of production today increasingly depends on how widely and fully the results of scientific discoveries and scientific and technological advances are used in the economy. 107

Technological change typically takes the form of a wholly new product or a new process of making an existing product or new ways to organise or manage industrial establishments. 108 For example, terylene – one of the great synthetic fibres, D. D. T., hot strip rolling of steel sheets, to mention just a few, are inventions associated with the names of industrial laboratories of private corporations.

An Important characteristic of the modern corporation is that it not only influenced by technological changes, it spends considerable sums of money in an effort to influence the rate and direction of that change. A Corporation can influence technological change of far-reaching effect in industrial design and output through its Research and Development unit.

So far as the effect of a high corporate tax on technology is concerned, it may be argued that the tax may adversely affect the willingness of corporation to effect such changes via rate of return on investment. When profitability of

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9. The provision for Losses to be carried forward has been provided in the tax laws of almost all the countries of the world including India.

corporations is reduced by tax, it leaves less resource at its command to undertake industrial research. Small firms may be affected more heavily than giant ones due to economies of scale: expensive and sophisticated equipment's and a large staff are needed for efficient research and the former in most cases, may be unable to foot the bills. There is yet another reason as to why corporations may be unwilling to invest in research where corporate tax rate is high. It is argued that in a capitalist economy, in which the profit motive is the domain of economic activities, firms often need to concentrate their resources on project, which yield quick returns. As research is a long-drawn process expected to produce results in the distant future, industrial research may be least understood by a stockholder, resulting in the projects not coming forth.

Against this, it may be argued that the incentive to spend money on research and development depends, among other factors, on 'competitive pressure to which firms are subject and the size and security of their Markets.'\(^{109}\) As a matter of fact, technology advances according to rules of its own. Professor Hamberg emphasises this and says, "If it is true that modern management of large corporations are not profit made, grasping ogres, anxious to maximize earnings, it follows that the drive for profit is no longer reliable spur to innovations it was once

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thought to be……. It provides an inspiration to innovate all its own”. A recent study of 61 inventions since 1900 suggests that more than half of them were discovered by “independent investors, working alone, unaffiliated with any industrial research laboratories”, and their inventions include a wide range of products: air-conditioning automatic transmission, Bakelite— the first commercial plastic, the cotton-picker, the jet engine, and streptomycin, to list only some of them. In fact, firms carry on very little or on research work at all; they simply concentrate on manufacturing. Most of the research work carried out by governments departments in their laboratories. However, even if it is taken for granted that corporation tax can influence the growth of technology adversely, it does not hold good so long as expenditure on scientific research is wholly or partly exempted from “taxable income” as provided in the tax laws of most lands. Moreover, research need not be carried out essentially by all firms because this may result in ‘duplication’ and hence waste of scarce resources. “The new lands need not develop,” aptly observes Professor Samuelson, “still unborn Newton’s to discover the law of gravity: they can read about the low in any book. They need

111. Ibid., P- 203.
112. The C S I R of the Govt. of India meets a major portion of costs involved in Industrial Research.
113. For example, Sec.35 of Indian Income Tax Act. Wholly exempts expenditure incurred on scientific research with approved institutions.
not go through the slow, meandering climbs of the Industrial Revolution: they can find in any machine catalogue wonders undreamed of by the great inventors of the past. Thus, corporations can hope to benefit by importing and copying technology of advanced nations and need not waste on duplicating research.

As 95 per cent of technology is developed in advanced countries, the need to import it is obvious, but it is argued that importing technology is not an easy task for developing economies to confront. The tax which the government of importing countries levy on royalties or technical services often impede the transfer of technology. The fact is that these countries view royalties as a thinly veiled profit distribution rather than as a legitimate expense of conducting business. This results in denial of royalties to the exporting countries or limitation of the amount of such services or dependence on government’s approval of the ‘technology transfer agreement’. Though certain amount of deductions are allowed by the Income-tax legislation’s of importing countries, it is limited to an arm’s length only. High taxation, therefore, clearly acts as a barrier for advanced countries to export and developing countries to import technology, which is such an important tool of economic growth. Liberalisation in the tax rate has, therefore, been advocated to solve the problem.

The foregoing discussion suggests that corporation tax may not impair technological advancement provided proper advantages given in tax laws are utilised. However, it depends on the degree of significance the government and corporations attach to the development of technology, and also on the tax structure of individual country in allowing tax deductions on research or importing technology and above all, on the stage of economic growth and the preference for immediate gain *vis-a-vis* long range perspective. Assuming these factors as favourable, corporation tax is not likely to affect technology adversely.