PART-II : THE BURDEN OF CORPORATE TAXATION

CHAPTER-3

General

a. Policy Objectives

The distribution of the corporate tax burden falls in three stages. It falls:

1. On shareholders;
2. On recipients of capital income in general;
3. On wage earners in the corporate sector, or on the consumers.

Whatever assumptions may be made, the tax burden is ultimately assigned to consumers in various income-brackets. If the corporation tax is assumed to fall on the shareholder, it would be assigned according to the distribution of dividend income; if it is assumed to pass on to the consumer, it would be assigned according to the distribution of consumer expenditures.

The implications of alternative corporate tax systems under different assumptions of personal income tax rates are at variance.

Under the classical system (as existing now) the burden of corporation taxation would be more, as compared to the split rate or imputation system. It is assumed here to consider only one stage, where the corporation tax is assumed to fall on the shareholder, assigning according to the patterns of distribution of dividend income.

b. Socio-Economic Implications

The nature of corporation tax incidence has important bearing on various aspects of tax structure design, including the most important aspect, yet to be fully acknowledged by the Income Tax Legislation of integration of the corporation and personal income taxes

1. Musgrave & Musgrave; Public Finance in Theory and Practice, 11th Edn, 390
The aspects of integration presuppose one premise that for increasing the rate of investment and savings, as large a portion as possible of the increments in income generated by economic development would be siphoned into desirable directions. The wizard on public finance, V.K.R.V. Rao states:

"The structure of the tax system should be such that an increasing proportion of the increments to national income gets automatically syphoned off into the public exchequer without involving any additional tax effort on the part of government".

Indubitably, an attempt has been made by virtue of the Finance Act, 1978 by inserting section 80CC to integrate the corporate-source income and the personal income. The obvious proof of this fact is that just after 80C, which deals with the deduction in respect of life insurance premia, contributions to provident fund, etc., which have the effect of lessening the burden of personal income tax, section 80CC occurs.

The full integration system completely integrates the corporate tax with the personal income tax, both as regards the distributed and the non-distributed components of profits. The dividend recipient is construed to receive not only the cash dividend actually distributed but also a proportionate share of non-distributed profits retained by the corporation (in proportion to the equity shareholdings in the total equity capital) and this combined corporate-source income (actual and deemed to be received) constitutes the personal tax base, together with other non-corporate-source income.

In essence, section 80CC acknowledges that the burden of corporate taxation falls on the shareholder too. It provides tax exemption on the basis of amount saved and invested itself - deduction in the computation of total income of an amount equal to 50% of the

cost of equity shares to the assessee, who may be an individual, an
HUF or an association of persons or body of individuals. It is
important to note that unlike many incentives in the Income Tax
Legislation, section 80CC has nothing to do with the income flowing
out of such an investment. But certain conditions which have been
laid down in order to avail the benefit of this 'deemed corporate-
source income' defeat the very concept of partial or full integration
system.

Sub-section (3) of section 80CC states that equity shares
should form part of an 'eligible issue' of capital, which means the
fulfilment of the following conditions:

1. The issue is made by a public company;
2. The issue is an issue of capital made by the company for the
first time;
3. The shares forming part of the issue are offered for
subscription to the public.

In the case of private companies going public, issue of equity
shares made for the first time after such a conversion would qualify
as an 'eligible issue', if two further conditions are satisfied:

1. While a private company, it should not have declared,
distributed or paid any dividends;
2. While making this 'eligible issue', this issue must be at
par and not at a premium.

Further sub section (4) states that the assessee should have
acquired the equity shares by any of the following modes:

1. Subscribing to the shares in pursuance of an offer for
subscription to the public;
2. In pursuance of a reservation or an option in his favour
by reason of his being a promoter of the company;
3. Purchasing the shares from an underwriter of the company.

It is clear from these conditions that shares purchased on the open market or through negotiations would not form part of 'eligible issue' of capital. Some three very anomalous conditions are there which have the tendency to sap away the very vitality of section 80CC - one of the most beneficial and pragmatic provisions in the Income Tax Code inserted during the course of this decade. One, the issue is an issue of capital made by the company for the first time. Two, while a private company, it should not have declared, distributed or paid any dividends. Three, the private company after its conversion to public company, should not make the issue at premium.

Notwithstanding the nuances of law, at least this condition is understandable from economic point of view, that it would be regarded as an 'eligible issue' of capital, if made by the company for the first time; but further two conditions applicable to a private company going public are not in line with the pragmatic scheme of section 80 CC. Section 78, Companies Act, 1956 takes enough care of those issues which are made at premium. Perhaps the reason which might have impelled the legislature could be that since the benefit is related to the 'cost of such shares', the extant of benefit would be correspondingly more to the assessee taking equity shares in those private companies going public which could issue shares at premium. In other words, this measure could recoil on those companies who are not in a position to exhibit their shares at premium. It is submitted that if it is so, it is too specious an argument. On some similar counts, even this condition that while a private company, had not declared, distributed or paid any dividends hardly stands the scrutiny of a fast-developing economy.

Perhaps, Explanation below sub-section (1) states that only
that much amount towards the cost of the shares shall qualify for
deduction which has been paid 'within a period of six months from the
end of that previous year', and 'the amount so paid shall be deemed to
have been paid by the assessee towards the cost of such shares in that
previous year'. The inevitable implication of this Explanation would
be that the qualifying amount for deduction in the initial year may
not be 100% in most of the cases. It is well-established practice of
the corporate world that usually 25% of the share value is paid as
application money, 25% on allotment of the shares and the balance in
equal instalments on the basis of 'calls' from the company.

Does 'eligible issue of capital' refer to the actual issue on
the basis of allotment of shares, or does it mean an issue authorised
at the time of incorporation? Does 'eligible issue of capital' refer
to the issuance of 'prospectus', even in the case of a public company
having already a 'paid-up capital'? Perhaps, the answer has been
given by Explanation 1 to sub section (3) which reads as under:

"Explanation 1 - If any question arises as to whether any issue
of equity shares would constitute an eligible issue of capital
for the purposes of this section, the question shall be referred
to the Central Government, whose decision thereon shall be final".

It is submitted that in order to make the scheme of section
80 CC more meaningful, Explanation to sub section (1) may be omitted.
Further, both the conditions applicable on the conversion of a private
into a public company, by way of second proviso to sub section (3) may
also be omitted. It would be in conformity, as a matter of fact,
with the true perspective of an integration system, however partial
it may be.

3. Since the quantum of deduction is only 50% of the cost of
equity shares acquired on the 'eligible issue of capital'.

3.
Obviously, integration system leans in favour of 'imputation system', as regards the corporate-source income. It encourages the mitigation of double taxation of part or whole of corporate-source income. Credit is being given for corporate tax paid on dividend income; there is a refund, if the corporate tax paid is more than the personal income tax liability on dividend income. In other words, the extra tax deducted at the corporate level can be first adjusted towards any tax liability on non-corporate income, and if even then, such liability is less than the corporate tax paid, a cash refund is receivable.

The prevalent classical system of taxation of corporate-source income does not seem to have succeeded in resolving or limiting the following problems; rather, the problems have a vortex tendency with the passage of time, generating in the process, economic, financial and politico-economic embarrassment:

1. Often stagnating level of capital formation;
2. Poor rate of growth of capital assets;
3. Low rate of return on equity investments;
4. Depression in the domestic capital market;
5. Significant, may be alarming, degree of inequality in distribution of income and wealth;
6. Flow of non-resident investments, at times, in undesirable or low-priority areas.

It is submitted that the 'imputation system' may be considered to be an effective mechanism for resolving or ameliorating the problems identified above. One, this system brings in a greater degree of neutrality in the taxation of dividend recipients in different income groups, more so, in favour of non-high income groups. Two, the inclusion of gross-up dividends into the personal
income tax base would raise the total tax liability on aggregate income of individuals, thereby bringing in a greater degree of progressivity in the overall tax system and reducing the inequality in distribution of income and wealth. Three, the imputation system would generate a cyclical flow of resources from the corporate sector via the government (tax) and the shareholder (dividend and tax credit) back to the corporate sector (either in the form of fresh equity or loan capital), with the possibility of an accelerated multiplier effect in operation.