Chapter II

Corporate Taxation:
Theory and Practice
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1. Introduction

Countries all over the world have adopted the corporation income-tax1 as a prominent form of direct taxation. Revenue from this source constitutes a predominant portion of total revenue in most countries. In India too, taxation of corporate incomes forms a distinct and important instrument of fiscal policy and its importance has grown considerably over the years.

Taxation of corporate incomes is a subject replete with controversies and problems. Some economists question the very justification for treating companies as separate taxable entities2. Some others question the methods3 adopted for doing so. Similarly, some economists consider that the taxation of companies leads to double taxation of dividend incomes4. Some others raise doubts about the incidence and impact of the corporation income-tax5. Yet others question the mechanism for

1In the following discussions, the terms “corporate tax”, “corporation income-tax” and “corporation tax” have been used interchangeably, to mean a tax levied on the profits of companies.


levying and collecting such taxes. Here, an attempt is made to briefly discuss some of the important controversial issues relating to the taxation of companies and to study the problems in the existing scheme of corporate income-taxation in the country.

2. The Case for Corporation Tax

Modern Governments all over the world, particularly those in the developing countries, need vast revenue resources to meet the growing needs of public expenditure. Many of them have embarked upon programmes of providing a "welfare state" to their citizens, where basic developmental needs in terms of health care, education, sanitation and infrastructural facilities such as roads, railways, power, transport, etc., have to be provided for, to an ever increasing population. Particularly in the third world countries, demand for social sector spending has reached an all-time high, for alleviating the scourges like poverty, unemployment, illiteracy, etc. These demands have placed increasing pressure on public finances and Governments have had to explore ways and means of mobilizing additional revenue.

In this context, Governments have placed increasing reliance on taxation as a means of raising the required revenue resources and the taxation of corporate incomes has become a major and important element of their taxation policy. The corporation income-tax plays a crucial role not only in the developing countries, but in the developed countries as well. However, doubts have been expressed in certain quarters about the desirability of taxing corporations. In view of these doubts, it is necessary to examine some of the most important reasons for treating companies as separate taxable entities.

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(1) **Viable economic entities**: Corporations are formed as viable economic entities and engage in activities quite distinct from those of their shareholders. The shareholders in large, publicly held corporations have only indirect and remote influence on their management policies. All business decisions are taken and the management of the day-to-day affairs of a company are carried on by an elected Board of Directors, with the Managing Director or an executive head appointed by the shareholders. Companies possess characteristics and behaviour patterns that have very little relationship with those of their shareholders. They are capable of making economic decisions and possess independent taxable capacity. It is therefore in the fitness of things to treat them as separate taxable entities.

(2) **Special privileges**: Corporations are conferred with special privileges through incorporation like the limited liability of shareholders. The limited liability of the shareholders is in terms of the extent of their responsibility towards the financial or other decisions of the companies. Although they enjoy all the benefits from the profits made by the companies, their responsibility towards the debts or losses incurred or other obligations entered into by the companies, remains confined only to the extent of the face value of the shares owned by them. Further, companies are recognized as legal entities under the Income-Tax Act and are permitted to enter into partnerships or contractual or collaborative arrangements with other entities, within or outside national borders, as if they were individuals in their own right. These unique privileges are not available to any other types of business organizations. They are by no means ordinary.

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ones. Companies should pay the society for such privileges that the latter has bestowed on them. The right of incorporation, the limited liability provision and the establishment of corporations as legal entities give governmental authorities the right to levy taxes on the incomes of such corporations.9

(3) **Equity in taxation:** Unless corporate incomes were subject to tax, individuals could avoid the personal income-tax by accumulating incomes in corporations. Shareholders of companies, who usually belong to the middle- and high-income groups, could escape personal income taxation on their incomes from corporations. This would result in violation of equity. Thus the corporation income-tax is necessary not only from the point of view of its own desirability but also to protect the equity consideration and revenue potential of the personal income-tax10.

(4) **Progression in the income-tax system:** A progressive personal income-tax structure is looked upon as a desirable economic objective, particularly in developing countries, where disparities in the distribution of incomes and wealth are more pronounced. Assuming that the corporation income-tax is paid by owners of capital, the tax contributes to a more progressive overall tax system, even if the corporation income-tax itself is not made progressive. This is because owners of capital have better taxable capacities than individuals in the lower and lower-middle income classes whose incomes consist mainly of wages. Without the corporation income-tax, the tax system would lose the tax that contributes most to progression in the top brackets of taxpayers11.

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(5) Profits versus retained earnings: If there is no tax on the net income of the corporation, undistributed corporate profits (profits not paid out as dividends) would escape annual taxation. This would create strong incentives for companies to retain earnings rather than pay them out as dividends. Retained earnings tend to give shareholders income in the form of long-term capital gains as and when they sell their shares. Long-term capital gains are taxed at significantly lower rates than ordinary incomes under the personal income-tax. In other words, if there is only a personal income-tax and no tax on corporate profits, undistributed profits would escape taxation until incomes are realized by shareholders through sale of shares; even then, the tax burden would be less than what falls on regular income since capital gains are generally given concessional treatment. Thus the absence of a corporation income-tax creates a tax differential between profits and retained earnings and violates equity in taxation12.

(6) Windfall gains to existing shareholders: Elimination of the corporation income-tax which already exists would lead to substantial unexpected windfall gains to existing shareholders and create inequity in the tax system13.

(7) Revenue requirements of countries: The corporation income-tax contributes a substantial portion of revenue collected by Governments in most countries. In India, the share of corporation income-tax has grown steadily from 22.44 per cent of all direct taxes collected in 1950-51 to 51.24 per cent in 1994-95. As a proportion of the total revenue receipts of

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the Government of India, the share of corporation tax has increased from 0.10 per cent in 1950-51 to 15.6 per cent in 1994-95\(^{14}\). In Australia, the reliance on corporation tax was to the extent of 15 per cent of total tax revenue in 1981, whereas the reliance ratios for the USA and UK were 11 per cent and for New Zealand 11 per cent in the same year. In the ASEAN\(^{15}\) countries, the reliance ratios of the corporation income-tax was 78 per cent in Indonesia, 50 per cent in Singapore, 36 per cent Malaysia, 13 per cent in Thailand and 12 per cent in the Philippines in the year 1981\(^{16}\). In India as well as in the African countries of Sierra Leone, Ghana, Nigeria, Kenya, Uganda, Tanzania and Rhodesia, the yield of the corporation income-tax exceeds the yield of the personal income-tax\(^{17}\). At a time when the corporation income-tax is playing such an important role in the public finances of all the countries and when the public expenditure needs of Governments are increasing manifold, there is no justification for doing away with such an important source of revenue\(^{18}\).

(8) Corporation income-tax already exists: The fact that the corporation tax already exists is in itself a valid reason for continuing with the levy of this tax. As Asher aptly puts it, there is an element of truth in the adage “an old tax is a good tax”\(^{19}\), insofar as companies have adjusted their affairs in expectation of the continuation of corporation income-tax. Corporations are popular targets for raising revenues. It is still not clear who actually pays the tax and this attribute of the corporation income-tax


\(^{15}\)ASEAN stands for Association for South East Asian Nations


\(^{19}\)Ibid.
makes it easy to levy. This tax is also politically more convenient to impose since corporations do not have votes. Further, corporation income-tax is easy to levy, collect and administer because corporations usually keep better accounts. The books of account of companies can easily be scrutinised since all companies follow uniform method of accounting as required under the Companies Act and are pre-audited by qualified professionals, unlike in the case of individuals, proprietary concerns or partnership firms.

(9) *Withholding tax:* The corporation income-tax can be viewed as a withholding tax on those who receive capital incomes from corporations in the form of dividends (distributed profits) or long-term capital gains (retained profits). If a withholding tax is imposed on wage-earners in the form of taxes deducted at source from salaries, then there is no justification for sparing receivers of capital incomes from companies from such a levy. Further, if the incomes of individual businessmen are subject to a personal income-tax even when they are saved or ploughed back into the business, then equality of treatment would require that company profits should similarly be taxed when they are ploughed back into corporate businesses in the form of retained earnings.

(10) *Less harmful effects than other taxes:* Heavy reliance on indirect taxes may lead to a high-cost economy. It may also accentuate disparities in the distribution of incomes and wealth. Because indirect taxes cannot

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20Stiglitz, J.E. (1988a): *Op. Cit.*, p. 587, citing this reason for levying a corporation income-tax, further observes that most taxpayers never know how much of their income is reduced by the corporation income-tax and this precisely helps the politicians to decide in favour of levying the tax; Asher, M.G. (1986), *Op. Cit.*, p. 94, also supports the argument that since corporations do not have votes, they could be easily taxed without any political repercussions.

21Withholding tax means a tax which is withheld or deducted at source from an income before the income reaches the hands of the earner.

inherently discriminate between the rich and the poor taxpayers, dependence on them would place undue tax burdens on the lower income classes of society, quite out of proportion to their ability to pay. This could lead to the growth of a general feeling of unfairness among masses and result in social tensions. On the other hand, dependence on the personal income-tax alone might give rise to rampant tax evasion, administrative difficulties and corruption. Compared with other taxes, the corporation income-tax would have less harmful effects on the economy than other taxes\textsuperscript{23}.

It is clear from the above discussion that a corporation income-tax is economically justified, administratively feasible, politically convenient and socially desirable. After considering these theoretical arguments in favour of levying a separate corporation income-tax, it would be relevant to consider some of the important objections raised against the tax as well.

The first objection is that separate taxation of corporations ignores the fact that the tax must ultimately be paid by individuals: it leads to the double taxation of dividend incomes in the hands of the shareholders, thereby increasing the effective rate of taxation on corporate investment\textsuperscript{24}. However, the problem of double taxation of dividend incomes has been successfully overcome in most countries by giving some or the other form of relief to dividend incomes in the hands of individual shareholders. Hence this cannot be a serious objection against the levy of a tax against corporations who have taxable capacity distinct from that of individual shareholders.

Secondly, it is claimed that separate taxation of corporate incomes creates distortions in economic decisions of companies; that it unduly influences the modes

\textsuperscript{23}Asher, M.G. (1986): \textit{Op. Cit.}, p. 86, also supports this viewpoint.

of financing investments and the form of business enterprises. It is also claimed that a separate corporate income-tax cannot be defended on efficiency grounds because of the distortions so induced by it\textsuperscript{25}. This objection can also be easily overruled because it is possible to eliminate the chances of such economic distortion by giving equal treatment to debt and equity finance while taxing companies and by making a corporate tax system neutral to the modes of financing. Further, when other forms of businesses such as partnership firms\textsuperscript{26} are subject to income taxation, it is the non-taxing of corporate incomes which would create inequity and inefficiency in the economy and not the taxing of corporate incomes.

A third objection to the levy of a separate tax on corporate incomes is that the claim to all income rests with individuals who only carry taxable capacity; Musgrave observes that "corporate incomes should be taxed only to the shareholder and integrated into the recipient's personal income-tax"\textsuperscript{27}. It is not possible to accept this contention since, in the absence of a corporate income-tax, companies would rather retain all their earnings and there would be no question of taxing individuals who may not receive any incomes from companies at all. Further, it is not true that individuals alone carry taxable capacities. As companies enjoy independent economic power, they have taxable capacities of their own.

For the above reasons, corporate incomes continue to be taxed in most countries and rightly so. The problems caused by eliminating corporate income-tax appear to be more serious than those likely to be faced if a separate corporate income-tax is levied. There is therefore a very strong case for continuing with the levy of the corporation income-tax.

\begin{quote}
\textsuperscript{26} The Indian Income-Tax Act does not recognize partnership concerns as distinct taxable entities and deals with them as individuals.
\end{quote}
3. The Incidence and Impact of Corporation Income-Tax

Although the corporation income-tax is considered a *direct* tax, many economists hold the view that the tax is not actually borne by companies themselves, but are passed on to some others. Thus, the incidence of a corporation income-tax is said to be shifted to entities other than the companies on whom the tax is levied. Here, the term ‘incidence’ is used to mean the location of the ultimate bearer (i.e., payer) of the tax (and not in the Musgravian sense of change in the distribution of income as a result of changes in budget policy).

Since corporation tax is levied on company profits, it is important to understand what constitutes the profits that are taxed. The excess of revenue receipts over revenue costs, without taking into account the cost of capital, is what companies report as their *gross* profits. The capital required by companies for conducting their businesses and for buying fixed assets, stocks, etc., may either be borrowed from the market or raised from shareholders as equity finance. If the cost of borrowing funds, i.e., the interest on borrowed capital, were subtracted from the gross profits, the resulting figures represent the *net* profits. However, the net profit is arrived at before allowing for the cost of capital raised through equity issues, i.e., before providing for the payment of dividends to the shareholders. The net profits must therefore be sufficient to make allowance for payment of dividends at a rate which is attractive to the investors. Sometimes, companies may earn profits which are in excess of the net profits required to allow payment of the promised rate of dividends.

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29 This topic is discussed here briefly, so that an important area of controversy in the taxation of corporate incomes is not ignored. It is not intended to go deep into the theoretical aspects of the incidence and impact of corporation income-tax since such a discussion would be outside the scope of this study.


dividends on equity capital. The amount by which the net profits so exceed the net profits is termed *pure* profits.

The incidence of a corporation income-tax depends on the structure of the tax\(^\text{32}\). A corporation tax which is levied only on the *pure* profits of companies is said to be neutral. If the tax is ‘neutral’, then it falls first on entrepreneurs (the company’s management). If the supply of entrepreneurship is not responsive to its rewards, the tax will be paid by the entrepreneurs and it will not be shifted. If entrepreneurs are responsive to their rewards, then the burden of the tax will be shifted to consumers either in the form of higher prices for the company’s products or in the form of loss of efficiency caused by the withdrawal of entrepreneurs from the management of the company.

If a corporation income-tax is not neutral, it will fall on those who supply capital to companies (i.e., the shareholders) in the form of reduced profits. The consequent reduction in the dividends distributed would imply a reduction in the rate of return to their capital. The shareholders will have to bear the burden of the tax either in the form of low returns to their capital or in the form of lower capitalized values of their share holdings or stocks.

This is likely to happen if there are no better investment opportunities available to shareholders or if the companies are already maximizing their profits. However, if there are other profitable investment opportunities (including foreign investment opportunities) available to the shareholders, then companies cannot pass on the burden of the tax to shareholders. The resulting reduction in profits would be passed on wholly or partly to consumers through higher prices. Similarly, if companies are already maximizing their profits, they cannot shift the burden of the tax to consumers in the form of higher prices.

In the short run, the total stock of capital is constant and capital resources cannot be shifted from one employment to another. The company which is already maximizing its profits cannot raise the prices of its products. It cannot lower wages either, since the labour costs are already at the accepted minimum levels since profits are being maximised. Under these circumstances, the incidence of the corporation income-tax would be on the owners of capital (shareholders)\textsuperscript{33}.

In the long run, the burden of a corporation income-tax could be shifted to employees of the company in the form of lower wages to the extent that the supply of labour is inelastic. To the extent that the demand for the products is inelastic, the tax could be shifted to the consumers\textsuperscript{34}.

The incidence of a corporation income-tax also depends on the structure of the markets in which companies operate. If companies are operating in a competitive market, they may not maximise profits, either because it is socially unacceptable, or for fear of anti-trust (or anti-monopoly) action from Government or for any other reason. In such a case, a corporation tax may be passed on to consumers in the form of higher prices, so as to retain the pre-tax rate of profits. Then, the incidence of the tax is on the consumers. If the corporation is operating in a monopsony labour market, it might shift the burden of the corporation income-tax to labour in the form of lower wages. In that case, the incidence of the tax is on the labour.

Thus the incidence of a corporation income-tax could be on any one of the four groups of persons, namely, the entrepreneurs, the shareholders, the employees


of the company or the consumers of the company’s products. However, there is no definite conclusion about the incidence of the corporation income-tax. Some economists consider that, if shareholders or owners of capital bear the burden of the tax, then there is no shifting at all. If the short-run incidence of the tax is fully on consumers, the tax is said to be shifted forward. If the incidence is on entrepreneurs or employees of the company, then the tax is said to be shifted backward. The tax burden may, in fact, be distributed among these groups and the degree to which each group bears the burden of the tax depends upon the structure of the tax and of the markets in which companies operate.

On the whole, it appears that the full burden of the tax may not fall on shareholders alone, particularly in the long run. Some shifting may definitely occur because all corporations do not maximise profits, nor do they operate under perfect market conditions. However, in the long run, the ability of corporations to shift the tax appears to be limited. Companies may, instead of shifting the tax burden, try to ‘absorb’ the taxes by foregoing some portion of their pure profits or by lowering other functional or operational costs, for retaining the other advantages of the corporate form of enterprise.

The question of what effect a corporate income-tax would have on corporate savings and investment depends on the incidence of the tax. If companies are able to shift the tax to consumers or to others, there may not be any reduction in corporate profits. Savings and therefore the rate of return on corporate investment may not decline as a result of the imposition of the tax. However, if companies are not in a position to shift the tax burden to others, the rate of return on corporate investment could decline.

Assuming that there are only two sectors in the economy, namely the corporate and the non-corporate sectors, that perfect competition prevails in the market and that corporation income-tax is the only tax being used, Harberger analysed that, in the short run, companies maximising their profits cannot change their output levels and the tax on profits cannot be shifted. The corporation income-tax therefore decreases the net return to capital. This results in an over-allocation of productive resources to the non-corporate sector and in loss of efficiency in the allocation of resources. If the supply of capital is elastic to the rate of return, there would be an additional loss in efficiency caused by the reduction in capital stock.  

In the long run, the increased supply of capital to the non-corporate sector would result in the reduction in the rate of return in that sector as well. The return to capital for the economy as a whole would decline as the tax decreases the return to capital earned throughout the economy. It makes no difference where or to what use the capital is put.

Harberger’s analysis of the effects of the corporation income-tax in the short and long runs depends crucially on the assumptions of perfect competition and of the levy of corporation income-tax alone. However, these assumptions are too simplistic and in reality, there is neither perfect competition, nor is the corporation income-tax the only tax to be imposed. Most Governments impose a variety of taxes such as the excise duty, the sales tax and the personal income-tax and not corporation income-tax alone. The imposition of any tax may produce disincentive effects in the economy as a whole and there is no ground to single out the corporate income-tax alone as the cause for such effects.

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In fact, the disincentive effect of reduced return to capital brought about by the corporation income-tax may be less than that induced by the other taxes\textsuperscript{40}. Further, investment decisions in reality may be based on reactions conditioned by the prevailing state of optimism or pessimism, information or ignorance, rationality or irrationality of the investors or even political stability and instability. If public expenditure policies of governments are such as to finance productive investments, then the corporation income-tax may even result in an increase in private investment and not in the reduction of capital stock. Any adverse effects of taxation may be more than counter-balanced by the favourable effects of productive public investments\textsuperscript{41}. A classical system of corporate income-tax may even increase the rate of return to corporate investments, if it favours debt finance as compared to equity finance. Therefore, the conclusion that a corporation income-tax always depresses the rate of return to capital cannot be accepted as settled.

4. Classification of Corporate Tax Systems

Different systems of corporate taxation are practiced in the world. These systems differ from one another in terms of what is actually taxed and how it is taxed. Among various systems, there may be differences in the bases, in the rates, in the levels of integration of corporation income-tax with the personal income-tax and in the degrees of progressivity of the tax. Here, some major systems of corporate income taxation which are in vogue in different countries are discussed.

4.1 The Classical System

The classical\textsuperscript{42} system is one of the simplest systems of corporate taxation. The principle applied in this system is that the tax liability of the company should be

\textsuperscript{40}King, J.A. and King, M.A. (1978); Op. Cit., p. 182.


\textsuperscript{42}The term "classical" is not used here to imply what is understood by "classical economics" of Adam Smith, David Ricardo, J.S. Mill, etc., but is the name given to a system of taxing corporate incomes.
completely independent of that of its shareholders. Accordingly, the company pays a flat rate of corporation tax on its taxable profits, and then the shareholders pay the personal income-tax on their dividends. On the portion of the profits that the company does not distribute, but retains with itself as reserves, capital gains tax are paid by the individual shareholders as and when they sell their shares of the company and realise profits.

A company wishing to raise a given amount of finance may either use its retained profits, or issue new shares, or borrow the money and pay interest charges on the loan. Under a classical system of taxation, interest payments made on borrowed funds are allowed to be deducted from profits in assessing the company’s tax liability. However, no part of dividends is allowed to be so offset against liability to corporation tax. Thus the system discriminates between these two sources of funds, namely debt and equity finance and places a premium on debts as opposed to equity financing. This discrimination leads to an increase in the rate of return required to finance corporate projects.

Further, since capital gains are taxed at concessional rates, there is also a discrimination between taxes on distributed profits (dividends) and on undistributed profits (retentions). This creates a dividend-retained earning differential and tends to distort the choice between corporate and non-corporate forms of doing business. By discouraging companies from distributing the corporate profits, the corporation income-tax may affect the free flow of funds into new companies and encourage the merger of existing companies to the disadvantage of new enterprises.

Another important problem associated with the classical system of corporate taxation is that it leads to the double taxation of dividend incomes. The company pays corporation income-tax on that portion of its profits which is distributed as dividends. These dividends are once again taxed in the hands of the individual shareholders as part of their personal income-tax liabilities. This problem has given rise to a lot of criticism against the classical system and countries have tried different approaches to resolve this problem. This aspect is discussed in greater detail in a succeeding Section.

In spite of the above deficiencies, the classical system of corporate taxation has been adopted by many countries since it has the merit of simplicity. This system is followed in the United States of America, the Netherlands, Australia, Belgium, Sweden, India, Pakistan, Sri Lanka, Taiwan, Indonesia and Nigeria.\

4.2 The Imputation System

Under the imputation system, the company first pays tax on its entire profits at the rate of corporation tax. Profits which are subsequently distributed are regarded as having already paid income tax at a certain rate, which is called the 'rate of imputation'. This rate of imputation is usually set equal to the basic rate of personal income-tax. Shareholders are given credit for tax paid by the company by 'imputing' part of the company's tax liability to them at the rate of imputation. This credit is regarded as a prepayment of their income tax on dividends and is used to offset their personal income-tax liability on dividends. Shareholders have to pay additional income tax on their dividends only if their marginal rates of income tax exceed the basic rate.
The essence of imputation system is that when the shareholder receives his dividend cheque, he is deemed to have already paid income tax at the basic rate on the dividend. Since some shareholders have higher marginal tax rates and others lower, the amount of extra tax or of refund which is due is calculated separately for each of them.\(^{49}\)

4.3 The Cash Flow or the “Flow of Funds” System

The essence of a Cash Flow Corporation Tax is that all receipts and payments, whether current or capital, enter into the tax base and companies are taxed on their cash flow. Here, cash flow refers to that of the company and not to the cash flow to the shareholders. Interest payments are not allowed as a deduction. Under the cash flow corporation tax, expenditure on real items can be deducted, but the returns to the suppliers of finance, whether shareholders or creditors, cannot.\(^{50}\)

Some economists\(^{51}\) have observed that a flow of funds system of corporation income-tax is not suitable to developing countries. The system is said to encourage immediate capital expending, lead to tax arbitrage through transfer pricing among affiliates and create transitional problems as a result of eliminating interest deductions and lead to windfall losses to indebted firms.\(^{52}\) It greatly limits the taxation of capital income and results in a loss of revenue that developing countries can ill afford.\(^{53}\)


\(^{50}\)Ibid, p. 200.


4.4 The *Avoir Fiscal* System

Under an *avoir* fiscal system, the recipient of cash dividends is once again endowed with an imputed tax credit (the *avoir* fiscal), but this tax credit is reckoned as a certain fraction of the corporation tax which has been levied on the profits used to pay the cash dividend, instead of being reckoned as in the imputation system, simply as a given imputed rate of tax on the dividends\(^4\).

4.5 The Formula Apportionment System

Under a formula apportionment system, each State determines taxable income within its State on the basis of its State’s share of the corporation’s total property (property is defined as all tangible property, whether retained or owned, used to produce business income), payroll and sales\(^5\).

4.6 The Two Rate system

Under the two rate system, a lower rate of corporation tax is charged on distributed profits than on undistributed profits, as an alternative method of alleviating the double taxation of dividends\(^6\).

4.7 The Integrated System

Under the integrated system, each shareholder is deemed to have earned a fraction of the company’s profit equal to the fraction of its shares which he owns. The effect of this is that the company’s profit, both distributed and undistributed,


constitutes part of the shareholder’s personal taxable income. Once a year, each 
shareholder receives a statement from the company showing his taxable profits for 
the last year, together with a tax credit for the tax paid by the company on his behalf. 
The taxable profits would be added to his personal income.\textsuperscript{57}

The above discussion throws light on some major systems of corporation 
income-tax practiced in different parts of the world. The question of what 
constitutes the correct tax design for a country depends on the overall socio­
eeconomic goals of that country. In general, the tax system should be such as to 
promote foreign and domestic investment, corporate form of enterprise, allocative 
efficiency, and domestic saving, without ignoring equity considerations. As Asher 
has very rightly pointed out, “it is necessary that the corporate income taxes be 
designed in such a way as to make maximum contribution to the fiscal, economic 
growth and development, and other objectives of a country, or at least not hinder 
these objectives unduly.”\textsuperscript{58}

5. Corporation Tax in India

In India, companies have been treated as separately taxable units ever- 
since the introduction of income-tax in India in 1860. In the first systematic income-tax 
legislation enacted in 1886, profits of a company were taxed at a flat rate.\textsuperscript{59} Until 
1960-61, a form of imputation was in force with respect to the income tax of 
companies. It led to considerable administrative and compliance problems because 
the assessment of the tax liability of the shareholders depended upon the assessment 
of the company. Whenever there was a reassessment of the company, the 
assessments of the shareholders had also to be reopened.\textsuperscript{60} Tax treatment of

\textsuperscript{59}Sury, M.M. (1993): “Income-Tax in India since 1860”, \textit{Journal of Indian School of Political Economy}, 5:1, 
January-March; p. 1.
companies has varied through the various tax legislations enacted in India, namely, the Income-Tax Acts of 1886, 1918, and 1922, and the presently followed Income-Tax Act, 1961. However, the basic tenet that corporations form a distinct taxable entities has been preserved.

The classical system of corporate taxation is followed in India. The Chelliah Committee noted that, although the classical system exists in a number of countries, the view that corporations could be treated as entirely independent entities on whom substantial additional tax liability could be levied is not generally accepted. It felt that the ideal mode of taxing company profits would be to apportion it among the different shareholders, according to their share in the profits of the corporation concerned. However, since this was difficult to achieve in practice, it favored the retention of the existing "classical" system of taxation, with a lowering of tax rate for all domestic companies.\(^{61}\)

There is no unanimity among economists and policymakers that this system of taxation is best-suited for India. Kaldor observed that "the present system of direct taxation in India is both inefficient and inequitable."\(^{62}\) Some important problems in the existing scheme of corporate income taxation in India are discussed in the following paragraphs.

5.1 The Base of Corporation Tax

Revenue collected from corporation income-tax depends both on the base as well as on the rate of the tax. The term "base" can be understood from two different perspectives, namely: (i) from the point of view of the number of taxpayers; and (ii) from the point of view of what is actually taxed.

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Viewed from the perspective of the number of taxpayers, it is found that the base of corporation income-tax in India is not very wide because less than fifty per cent of all companies incorporated in the country are assessed to income-tax. There were 3,56,702 companies incorporated in the country as on 31.3.1995, out of which only 1,76,594 companies were in the records of the Income-Tax Department. The actual number of corporate taxpayers in the country during the period covered by this study is shown in Table-2.1.

Table 2.1: Number of Corporate Assessees in India

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As the Table shows, the average rate of increase in the number of corporate taxpayers was 11.94 per cent in the pre-reforms period. This rate has slowed down to 9.54 per cent in the post-reforms period, recording a fall of 2.4 percentage points. This reflects a trend which is quite contrary to the avowed reform objective of widening the tax base.

From the point of view of what is actually taxed, it has to be noted that the Income-Tax Act provides for the taxation of profits of companies, after allowing for all business expenses, including interest on borrowed capital. The deductibility of interest paid on borrowed capital erodes the tax base. By providing incentives to companies to borrow capital rather than raise finances from the capital market, it unduly influences the choice they make between debt and equity finance. It

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encourages managements to avoid going to the capital market. The Chelliah Committee recommended the removal of provisions exempting from income-tax the interest payable by the Government and various types of industrial undertakings and financial institutions on borrowing abroad for substantially increasing tax revenues.

To overcome such erosion of the tax base, some economists have recommended that the profits base should be modified by or replaced with a "flow of funds" base or a "costs" base. If a "flow of funds base" is adopted, the liability of a company to corporation tax is based not on its profit (excess of current receipts over current costs), but on the flow of the total receipts from the sale of certain goods and services over the total of expenditure on the purchase of such goods and services, whether these transactions be on current or capital account.

In the costs-based corporation tax, the wage component of corporate costs are excluded from the tax base. According to its proponents, the change in the tax base from profits to costs is bound to raise the net corporate profits. These profits, even if undistributed, would give rise to capital gains in the hands of the present shareholders. The levy of a tax on company capital would complement the proposed change in the base of corporation tax by discouraging inefficient use of capital.

Thus the base of corporate income-tax in India is narrow, both from the point of view of the number of taxpayers and from the point of view of what is actually taxed. The reform objective of widening the tax base has not been realised.

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There is a decline in the rate of growth of the number of taxpayers after reforms. Nearly fifty per cent of incorporated companies are still outside the tax net. The exclusion of interest payments on borrowed capital from the corporate income-tax has resulted in further erosion of the tax base. Although the Chelliah Committee recommended the removal of provisions allowing deductions for interest on borrowed capital, such a step has not been taken by the Government and the tax base continues to dwindle. To overcome the problems of shrinking tax base and bias in favour of debt finance created by the deductibility of interest on borrowed capital, some economists have suggested switching over to a flow of funds base or to a costs base, but such measures do not appear to be necessary. The goals of widening the tax base and removing the bias in favour of debt finance could be served even while retaining the profits base by the simple expedient of eliminating interest deductibility from the Income-Tax law.

5.2 Fiscal Incentives and Tax Expenditure

In addition to the deduction of interest on borrowed capital, the Indian income-tax law allows a large number of exemptions and deductions to companies. Such exemptions and deductions are allowed for achieving diverse socio-economic goals like rural development, conservation of natural resources, prospecting for minerals, development of small-scale industries, promotion of exports and encouragement of hotel, tourism and shipping businesses. Such a tax policy appears to be more harmful than beneficial to public interest, for the following reasons:

1) **Tax Expenditure:** Allowing of a large number of tax exemptions and deductions results in substantial tax expenditure to the Government. In assessment year 1993-94, the total deductions allowed to companies under just one Chapter of the Income-Tax Act in India was Rupees 3,86,75,044, which constituted nearly 50 per cent of the total incomes returned and 29 per cent of the gross incomes earned by companies in that year. As against
this, the tax paid by companies was only Rupees 3,53,64,993 and represented only 26.5 per cent of gross incomes earned by them in the same year. Thus, the deductions allowed to companies was more than 100 per cent of the income-tax paid by them. In addition to these deductions, companies also claimed exemption and deductions such as depreciation and those allowed under other Chapters of the Income-Tax Act. This means that there was a net negative effective rate of corporate taxation in the economy as a whole. Tax exemptions and deductions have thus constituted very large and invisible subsidies allowed to companies and such tax subsidies cannot be justified from a public policy perspective.

(2) **Divergence between statutory and effective tax rates:** Combining generous fiscal concessions with relatively high statutory tax rates leads not only to an erosion of the tax base, but also to wide variation in the effective rates of tax for different businesses. Since policymakers are not likely to take into account the prevailing effective tax rates while prescribing statutory rates, the divergence between the two rates creates distortions in economic decisions of Governments and adversely affects total tax revenue collected from companies.

(3) **Inequity in tax system:** The prevalence of fiscal concessions undermines horizontal equity in taxation of incomes generated from different sources or forms of businesses. High statutory rates operating in

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73This conclusion is strengthened by the data analysed in Chapter III of this Study.


combination with preferences and concessions tend to create divergence in effective incidence across activities, investments and forms of businesses, interfering with the choice of economic agents\textsuperscript{76}. The large differences in tax burdens created by the fiscal concessions among companies operating in the same economic circumstances are detrimental to national interest\textsuperscript{77}. These incentives confer windfall gains on some activities and many economic activities even in the formal sectors go untaxed while the rest are taxed at inefficiently high levels\textsuperscript{78}. Use of the tax system for promoting different socio-economic objectives undermines the equity of the system and leads to all kinds of distortions and anomalies\textsuperscript{79}.

(4) \textit{Complexity in tax laws and administration:} The tax exemptions and deductions make the tax laws very complex. Since tax laws are frequently amended either in order to introduce new tax concessions or to lay down the conditions for the allowability of such concessions or for expanding or restricting their scope, the complexity of tax laws increases tremendously. The tax deductions also complicates tax administration. It is extremely difficult for tax administration to monitor the activities for which fiscal concessions in the form of tax deductions are allowed and to prevent their misuse\textsuperscript{80}. The perverse incentives and the resulting tax evasion stretch the inadequate resources of tax administrations to the limit\textsuperscript{81}.

(5) \textit{Increased litigation and tax evasion:} A tax system which allows a large number of tax exemptions and deductions also gives scope to increased litigation. The allowability or otherwise of many deductions depends on

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{80}Ibid.
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the interpretation of statutes and satisfaction of a number of pre-
conditions. Differences of opinion between tax administration and
taxpayers in the matter of interpretation of the laws and rules governing
deductions and in the subjective satisfaction of officials of pre-conditions
for availing deductions make room for increased recourse to litigation.
This puts immense pressure on the tax grievances redressal machinery and
increases both the compliance and administrative costs of the tax. Misuse
of fiscal concessions also gives rise to tax evasion because of the 'loopholes'
created by the tax exemptions and deductions\textsuperscript{82}.

(6) \textbf{Feeling of unfairness:} An income-tax structure riddled with a plethora
of concessions and preferences gives rise to a widespread feeling of
unfairness because of the uneven incidence of the tax on different groups
of the same class of taxpayers\textsuperscript{83}. Since effective lobbying campaigns
launched by pressure groups rather than public interest often determines
the granting of fiscal concessions, taxpayers in general feel that the tax
system is unfair and tax compliance is adversely affected\textsuperscript{84}. A general
feature of taxation systems throughout the world is that tax systems have
tended to be frequently amended in response to the demands of various
pressure groups within the country\textsuperscript{85}. High statutory rates accompanied by
large number of incentives encourage tax avoidance and compromise the
fairness of the tax system\textsuperscript{86}.

(7) \textbf{Distortion in resource allocation:} Tax expenditure in the form of
exemptions and deductions distorts budgetary magnitudes and adversely

\textsuperscript{86}\textit{Ibid}, p. xvi.
affects resource allocation and equity. The costs of such incentives may be substantially higher and their benefits significantly lower than was previously thought to be true.

(8) **Objectives not attained:** The use of tax incentives to promote objectives like industrial dispersion, rural development, etc., hardly help. There is no evidence to show that the diverse socio-economic objectives for which the tax exemptions and deductions were envisaged in the first place have been achieved or that the removal of such incentives would adversely affect such objectives. In fact, there is now considerably more doubt about the ability of tax incentives to achieve their intended objectives.

(9) **Tax code not to conduct governmental policies:** Given the limited tax bases, poor compliance and enforcement in many developing countries, tax expenditures are often ill-suited to achieving individual policy objectives. The tax system should not be used to support the myriad policies which governments set for themselves. The income-tax law is not the right instrument to be used for conducting governmental policies.

(10) **Zero-tax companies:** Fiscal incentives granted to corporate assessees tend to result in large tax savings and negligible or no tax liabilities for many companies, for a number of years. There is no justification for sparing highly profitable and influential corporate groups from income-tax. The

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existence of many zero-tax companies, who benefit by the multiple concessions built into the Income-Tax Act, adds to the unfairness and inequity of the tax system. For the above reasons, there is an urgent need for a thorough restructuring of the incentives and rationalization of the corporate income-tax. Deductions allowed on expenditure on fundamental research, eligible projects and schemes, rural development programmes, payments for conservation of natural resources, donations to charitable institutions, etc., should be totally abolished. Such a step would be in tune with the recommendations of the Chelliah Committee, which recognized the problem of a shrinking tax base owing to increase in the number of tax exemptions and deductions offered to companies and called for the removal of unnecessary tax shelters.

5.2.1 Depreciation

In the context of Indian companies, any discussion on fiscal incentives cannot ignore the aspect of depreciation, which happens to be the most predominant of all deductions availed by the companies. Depreciation is a deduction granted to companies to make allowance for the replacement of their capital assets employed in business as and when such assets wear out or become obsolete. In common parlance, depreciation simply means a decrease in value of property through wear, deterioration or obsolescence, or the allowance made for this purpose in bookkeeping, accounting, etc. The object of providing for depreciation is to spread the expenditure incurred on an asset over its effective life time, and the amount written

97According to data collected from sample companies for this study, depreciation constituted nearly 81 per cent of all deductions availed in the post-reforms period. For details, please see Table-3.67 in Section 3.1 of Chapter III.
off during an accounting period is intended to represent the proportion of such expenditure which has expired during the period. The economic rationale behind allowing a deduction from income-tax in the form of depreciation is to take into account the opportunity cost of using capital equipment in a business or industry and to arrive at a true cost of capital to companies of its business.

Theoretically, depreciation must be spread over a period of time which coincides with the actual life-span of the asset concerned. However, in practice, the Indian income-tax law allows depreciation on most capital assets on an accelerated basis, that is to say, at a rate faster than necessary to take care of the normal wear and tear of assets and is often quite out of proportion to the actual life-span of such assets. This is clear when one compares the rates of depreciation allowed under the Income-Tax Act with those prescribed under the Indian Companies Act, for the same or for the same class of assets. For instance, certain types of industrial furnaces and boilers, renewable energy devices, certain electrical equipment, energy saving devices, etc., are granted 100 per cent depreciation in the year the assets are first put to use and there are yet other assets such as motor buses, aero engines and airplanes, air and water pollution control equipment, etc., which are granted depreciation at levels higher than those allowed under the Companies Act. Thus, the Indian companies avail tax deductions several times greater than the amount of tax they pay and depreciation comprises the predominant portion of such deductions.

The effect of allowing such accelerated depreciation has been to encourage companies to invest in capital assets only with a view to availing the depreciation benefits allowed under the Income-Tax Act, rather than to fulfill any genuine need for the assets, resulting not only in reduced tax collections, but also in misallocation of resources. Accelerated depreciation subsidizes firms according to their capital intensity and according to the extent to which they qualify for the special rules. It

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decreases the uniformity of taxation among industries by allowing more capital intensive industries lower effective tax rates⁹⁹.

There is a view that taxation system is not the appropriate place to introduce incentives for investment in plant and machinery, especially as business decision-makers should not allow tax considerations to play a major role in such decision-making¹⁰⁰. The international trend on the issue of depreciation rates for plant and machinery has been to equate the allowable depreciation rate for taxation purposes with the accounting treatment, rather than to give higher rates or even 100 percent write-offs in the year of purchase. The trend is for neutrality of treatment, rather than to try to influence the behaviour of businesses by means of tax incentives¹⁰¹. A tax regime that provides for accelerated depreciation therefore distorts economic decision-making of companies, apart from causing considerable loss to tax revenue.

5.3 The Rate of Corporation Income-Tax

In India, until recently, different rates of tax were used to tax ‘domestic’ and ‘foreign’ companies, ‘widely-held’ and ‘closely held’ companies and ‘industrial’ and ‘trading’ companies. In general, a domestic company was taxed at a lower rate than a foreign company. Among the domestic companies, the industrial companies were taxed at a lower rate than the non-industrial companies. The distinction in corporate tax rate between trading companies and industrial companies was abolished in the 1991-92 budget¹⁰².

⁹⁹This fact is confirmed by data obtained from sample companies for this study, as discussed in Section 3.1 and shown in Figure-25 in Chapter III.
¹⁰¹Ibid
The Chelliah Committee observed that the highest levels of compliance, revenue, efficiency and equity, could be obtained through a system of incorporating moderate rates on a broad base. It also noted that a lower tax rate had the merits of generating less disincentive effect and of mitigating the other inherent defects of the income-tax. Accordingly, it recommended that the rate of corporate profits tax be reduced to 40% within the period 1992-93 to 1994-95 and that the surcharge on the corporate tax be removed in 1993-94, bringing the rate down from 51.75% to 45%.

In accordance with the Chelliah Committee's recommendations, the 1994 Finance Act abolished the previous distinction between the tax rates for widely-held domestic companies (previously 45%) and closely-held domestic companies (previously 50%) and lowered both rates to a single rate of 40%. In keeping with the general reduction in corporate tax rates, the tax rate on foreign companies has been reduced to 55% (from 65%) with respect to income other than income from royalties, dividends and interest. The surcharge of 15% on all domestic companies with income exceeding Rs. 75,000 has been abolished by the Finance Act, 1996.

In India, the effective rate of corporation income-tax is lower than the statutory rates. In addition to reduction in the statutory rates, the post-reforms period has witnessed a substantial decline in the effective tax rates. This has created a wide divergence between the statutory and effective rates of corporate income-taxation. Owing to this phenomenon, the revenue collected from corporate income-tax, though seen to be increasing in absolute terms, has not increased to the extent it ought to have increased.

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105 Effective tax rate may be defined as the rate of tax obtained by dividing the income-tax actually paid by companies by the actual profits earned by such companies and multiplying the quotient by 100.
Rates of corporation income-tax should be fixed in such a way that they are not so high as to have disincentive effects on investment and risk taking. It should not be so low as to make unnecessary presents to companies of foreign governments. As Asher observes, "while deciding the correct rate of corporate income-tax is a matter of judgment, it is better to have low nominal rates coupled with efficient and impartial enforcement. High nominal rates, ineffective enforcement, and a multitude of tax expenditures complicate administration and create opportunities for inefficient switching of resources in response to arbitrary tax advantages. The objective should be to attain a desirable pattern of effective, not nominal rates."\(^{106}\)

Liberalized allowances and tax credits reduce the revenue productivity of the corporation income tax, if not accompanied by increases in tax rates. In countries where tax incentives are eliminated, the yield of the corporate tax remains at a low-level because the revenue is being used to reduce corporate tax rates. The corporation income tax has thus been whittled away during the past two decades even in the most developed countries. As Pechman suggests, "further cuts in the corporate tax rates should be resisted unless they are accompanied by structural revisions or rate increases that will raise offsetting revenues from corporations or high-income individuals."\(^{107}\)

Even after all the above downward revisions in the rates of corporation income-tax, there is still a lot of uncertainty about whether tax compliance would improve and whether tax evasion would come down. It may be true that high tax rates encourage poor tax compliance and tax evasion, which leads to a vicious circle of evasion and high rates. Even so, it is very difficult to pinpoint at what level the tax rates encourage tax honesty. While reduction of tax rates to a reasonable level reduces tax dishonesty, there is no guarantee that tax honesty and tax rates are


inversely proportional. It is also open to dispute that reduction of tax rate would automatically increase household and corporate savings\textsuperscript{108}.

Statutory rates of corporation income-tax have been traditionally high in India, but as a result of large number of tax exclusions, the effective tax rates for companies have tended to be quite low. The post-reforms period has seen substantial reductions in both the rates as a result of which, there has been no scope for a \textit{real} growth in tax revenues. Whatever growth is apparent seems to be only in nominal terms. The reduction in statutory rates has not been accompanied by the removal of tax shelters as recommended by the Chelliah Committee. Therefore, while contemplating any change in tax rates in future, the Government must also consider the prevailing levels of effective tax rates and not statutory rates alone. As of now, there seems to be no further scope for reduction in rates and removal of most of the tax exemptions and deductions allowed to companies is the only next logical step.

5.4 Double Taxation of Dividends and Integration of Personal and Corporate Income Taxes

The classical system of corporate income taxation involves the double taxation of dividends. Double taxation arises because dividends are subject to both corporation tax and income tax\textsuperscript{109} and increases the effective rate of taxation on corporate investment\textsuperscript{110}. If the incidence of the corporation income-tax is on the stockholder, the effect of double taxation is to impose the heaviest burden on dividends received by stockholder with the lowest incomes\textsuperscript{111}. This happens because corporation income-tax is a proportional tax and if it is shifted on to shareholders, it


falls equally on every shareholder, irrespective of each one’s level of income or ability to pay. Equity and efficiency considerations call for the integration of the corporate and individual income taxes and removal of double taxation. Removal of double taxation results in higher growth and productivity in the longer run and, consequently, in a larger tax base. Any loss of revenue in the short run resulting from the integration of the corporate tax with the personal income tax would be more than made up by its long-run beneficial effects\textsuperscript{112}.

Several methods have been recommended for eliminating double taxation. One such method is to permit corporations to deduct all or a portion of their dividends in computing taxable income. Under this method, the regular corporate tax rate is applied to undistributed profits and the tax on distributed earnings is eliminated. As a result, dividend and interest payments are treated alike and the discrimination against equity financing by corporations is discontinued. Secondly, the same proportion of the corporate income tax on distributed income is eliminated for all taxpayers regardless of their personal income-tax status\textsuperscript{113}.

Another method of partial integration of corporate income-tax with the personal income-tax consists of taxing corporate profits but providing credit for the corporate tax paid in the event that the profits are distributed to the shareholders. The general effect of this system is that distributed profits are taxed only at the individual level while retained profits are taxed at the company level or corporate level. Thus, the tax on dividends is brought in line with other sources of income from capital such as interest. This partial integration method is likely to provide less disincentives for distribution of corporate profits\textsuperscript{114}. Such an integration is greatly facilitated by low uniform rates of individual income taxes, alignment of the top bracket of individual income-tax rates with the corporate tax rates and elimination of

\textsuperscript{113}Pechman, J.A. (1989): Op. Cit., p. 51-52, feels that this method is the simplest and the most effective one for dealing with the problem of double taxation of dividends.
all concessions or preferences allowed in the taxation of corporate profits. Imposition of a final withholding tax on dividends at a modest rate has also been suggested 115.

To avoid double taxation arising from taxation of incomes from international capital flows, countries enter into bilateral tax treaties. These treaties generally recognize the right of countries to tax all incomes from firms within their borders, and leave it to the home countries to alleviate the double taxation. A system of exemptions, credits, or deductions generally eliminates most of the excess burden arising from taxing corporate incomes in two jurisdictions 116.

In India, a system of providing partial integration of the personal and corporate income taxes was tried by inserting a new provision in the Income-Tax Act of 1918. Under this provision, dividends received by a shareholder were included in his total income only for the purpose of determining the rate of tax on his other incomes and the dividends themselves were exempt from tax in his hands. Prior to 1960-61, a company was deemed to have paid income-tax on behalf of its shareholders on dividends declared out of income on which the company had paid income-tax. Each shareholder was entitled for a tax credit against his income-tax liability to the tune of the tax deemed to have been paid on his behalf by the company. This scheme was discontinued with effect from the financial year 1960-61. Since then all dividends received by shareholders have been subjected to personal income-tax 117.

The Chelliah Committee preferred integration of corporate income tax with personal income taxation, but did not find it practicable due to technical and administrative problems. It therefore recommended the continuation of the

“classical system” of taxing corporations treating them as separate legal entities, inspite of its deficiencies. It held that providing relief to existing shareholders was not justifiable as it would provide windfall gains to the latter who would have already discounted the tax liability on dividends while investing in shares. These distortions were claimed to be outweighed by the advantages of the classical system such as its simplicity, especially in international relations. It was argued that the above distortions resulted from other aspects of the tax system such as the deductibility of nominal interest payments, the special treatment of capital gains and the relative effective rates of tax on corporate and personal income. Lowering of corporate tax rates was thought to be adequate to mitigate much of the burden of double taxation of dividends.\footnote{Ministry of Finance (1992b): Op. Cit., p. 8.}

The problem of double taxation of dividends has since been sought to be ameliorated in India with effect from the assessment year 1998-99, with the introduction of the “Corporate Dividend Tax” which companies are required to pay on the dividends distributed by them during a particular year, over and above the normal corporate income-tax paid by them. Individual shareholders have been fully exempted from paying income-tax on their dividend incomes, excepting those received from the Unit Trust of India or from Mutual Funds. These changes have been brought about by the Finance Act, 1997.

5.5 Presumptive Taxation of Companies

It is observed that there is a considerable number of “zero-tax” companies in India which manage to get away with payment of no corporation income-tax by taking advantage of the large number of concessions and deductions available in the Statute Book. Some of the largest and most profitable corporations do not pay any
Various economists have suggested the levy of a presumptive tax on companies as the best method of ensuring that all corporations with taxable profits do pay the tax.

A presumptive scheme of taxation for companies enforces a floor revenue contribution from the largest potential corporate taxpayers, who are best placed to exploit corporate loopholes. It offers a way by which substantive base-broadening can be achieved in developing countries, given their economic structure and the information vacuum in which the tax administrations in these countries are forced to function. Rajaraman cites the immediate revenue success of the recent wave of asset-based minimum alternative taxes in Latin America as an evidence that “an indirect attack through a presumptive floor on the rate of return to assets is far speedier than any direct attempt at elimination of tax loopholes.

Assets are the usual but not the only possible base upon which to rest presumption of corporate taxability. In general, corporate presumption whether of simple or complex design has been successful in revenue terms. To the extent this reduces uncertainty in corporate incomes via greater macro-economic stability, it could more than outweigh the disincentive effects on investment of a rise in the tax burden. The most successful use of presumption could be with respect to large corporate taxpayers, as an effective tool against tax avoidance and evasion. Minimum capacity-based corporate presumption works. It can be introduced reasonably quickly and if well-designed, can carry incentives for performance and accurate reporting.”


\[122\] Ibid.
Presumptive assessment of hard-to-tax groups supplemented by a withholding system is looked upon as the key to a successful income-tax system. These approaches work best if rates are not too high or steeply progressive. They have the virtue of “reducing the opportunity for face-to-face negotiation between taxpayers and tax officials and hence the ease of bribery and corruption”\textsuperscript{123}.

The opponents of the presumptive scheme of taxation for companies argue that “the ‘zero tax’ situation of companies does not arise because of any illegality, but because the depreciation provisions and other concessions under the Income Tax Act are such that they ‘absorb’ the profits. They opine that the zero-tax phenomenon is a result of many allowances legitimately provided for in the Income-Tax Acts and feel that the benefits of the presumptive minimum tax may be more than offset by the vastly counterproductive effect that it unleashes against future investments in India and by the furious litigation it will give rise to. They argue that it would be far better to insist on tighter enforcement of tax laws and better compliance from corporates in the public as well as in the private sector than to introduce the presumptive minimum tax\textsuperscript{124}.

The opponents of the presumptive taxation schemes for companies also point to the past failures of tax administration in enforcing such schemes and argue that the idea of presumptive taxation of companies had to be given up in the past because the schemes envisaged for presumptive taxation of companies were found to be unworkable and counter-productive. They observe that the concept of minimum corporate tax is not in tune with the on-going economic liberalization policies and non-payment of tax by a profit-making company should be viewed as a growth-oriented measure and not as an undesirable phenomenon\textsuperscript{125}.

In India, there was an experiment with a minimum tax at 30 per cent of book profits (Section 115J), from April 1, 1988 to April 1, 1990. Although not presumptive in design, the intent of computing minimum taxable income at 30 per cent of book profits was to combat base erosion through exploitation of concessional loopholes, akin to that of a Minimum Alternative Tax (MAT). Its discontinuance was formally stated to be the withdrawal of the concessions which gave scope for avoidance, but there continue to be zero-tax companies today, including some of the largest corporate giants.\footnote{126}{Rajaraman, I. (1995a): \textit{Op. Cit.}, p. 1119.}

Tax policy-makers in India have already accepted the concept of a minimum tax on companies by enacting Sections 80VVA and 115J. Section 80VVA was enacted to compel highly profitable companies with zero-tax liability to avail tax incentives and concessions under the Income-Tax Act. However, the scheme had to be given up as it was substituted by a new section, 115J, which was introduced in the Finance Act, 1987. It was justified on the principle of ability to pay, but had only three years’ life. It provided for the levy of tax in the case of companies whose total income, as computed under the Income-Tax Act, was less than 30 per cent of book profits. In such a situation, the tax was to be levied on 30 per cent of the book profits as computed under the Companies Act. The provision was enacted to restrict the erosion of the base of taxable income on account of concessions. It was given up because the Finance Act, 1990, introduced what were referred to as ‘a package of measures for rationalizing the tax structure, including discontinuance of certain investment incentives having the effect of increasing the taxable income base’. But this has remained a dream and incentives are on the rise.\footnote{127}{Pandey, T.N. (1995): \textit{Op. Cit.}}

More recently, a scheme known as MAT (Minimum Alternative Tax) has been brought on the income-tax statute (with effect from assessment year 1996-97) mainly to rope in the zero-tax companies that pay no income-tax at all through...
meticulous tax planning. This scheme is still in the infancy of its operation, but has already met with stiff opposition; it is, however, too premature to comment on the success or otherwise of the scheme.

There is an overwhelming case for the using a presumptive tax scheme for taxing companies in India and the Minimum Alternative Tax Scheme currently in operation must be given a fair chance in implementation, before dumping the same as a failure. Criticisms against the scheme appear to be based more on past failures, but as long as zero-tax companies exist in India, there can be no rationale for not defining a minimum level of taxes to be paid by such companies, when they have actually earned profits. In designing the presumptive taxation schemes, the tax administration must, of course, be mindful of past failures and lessons therefrom. Clearly, it is difficult to accept non-payment of tax by companies as a growth-oriented measure.

5.6 Tax Avoidance and Evasion

The definitions of tax avoidance and tax evasion: The phenomena of tax avoidance and tax evasion are among the most widely acknowledged problems in the taxation of incomes worldwide. The usual definition of tax evasion is that it is the illegal manipulation of an individual's affairs in order to reduce tax. Tax avoidance is the arrangement of one's affairs within the ambit of law so as to reduce tax liability. However, if taxpayers go to inordinate lengths to reduce their tax liability, this could hardly be considered 'compliance', even if it were within the letter of the law. A better definition of tax evasion might therefore include non-compliance with the spirit as well as the letter of the law. Non-compliance is thus the failure of taxpayers to act in accordance with the statutory requirements or intentions of the tax law and administration without the application of enforcement activity.\textsuperscript{128}

Extent of tax evasion: Thirsk has pointed out that, in many countries, as much as one-half of all income tax is evaded and the greatest opportunities for evading taxes are available to richer rather than poorer taxpayers. Rampant tax evasion had rendered the tax systems in many countries inefficient and inequitable\textsuperscript{129}. The Chelliah Committee drew attention towards the alarming scale of tax evasion in India, though it did not attempt to estimate its magnitude, as this was not included in its terms of reference\textsuperscript{130}.

Causes of tax evasion: The causes of widespread evasion and disrespect for the tax system include the intrusiveness of tax administration, fear of arbitrary enforcement\textsuperscript{131}, weak tax administration and the low likelihood of being detected and penalized\textsuperscript{132}. In India, large scale tax evasion has been attributed to high tax rates, complex procedure of tax compliance, legal complexity leading to prolonged litigation, administrative lapses, inefficiency, corruption and nexus between influential tax evaders and political elements\textsuperscript{133}.

Methods of tax evasion: Evasion occurs through a myriad of channels such as failure to file a tax return, misrepresentation of incomes and expenses, use of fraudulent invoices and transfer pricing practices involving exempted or preferentially taxed activities\textsuperscript{134}. Gulati and Bagchi point out that “camouflaging personal expenses as business expenses is one important method by which companies could evade the income-tax. Under the present system of taxation, the financial stake of persons in control of the business can be quite low and personal


gains to them from camouflaging personal expenses as business firms can be quite considerable.

The position of those in control is stronger in these respects for incorporated, rather than non-incorporated firms. Relatively small increases in business expenses, with a view to accommodating consumption, can yield substantial personal gains to persons in effective control of even small-sized publicly held companies. For larger companies, the scope for accommodating personal expenses of those in control through relatively small inflation of business expenditures would be far greater. Ways in which consumption can be dressed up as business expense are numerous, and it is quite unrealistic to suppose that the practice can be stopped by prescribing limits to- or proscribing altogether- the deductibility of certain categories of expenditures. ¹³⁵

**Effects of tax evasion:** The effects of non-compliance- legal or illegal- are significant. There are economic effects such that decisions are taken for tax purposes rather than on commercial or economic criteria. There is the time and expense involved in non-compliance. There may be other psychic costs, such as exile for tax purposes. There are also equity effects- that economic resources are transferred away from those who comply with the tax system and towards those who avoid or evade. This may be considered inequitable since the more income a person has the more incentive there is not to comply. If it is perceived that only individuals who are wealthy or dishonest or both can benefit, this might reduce ‘tax morale’ and the willingness of the rest of the taxpaying population to comply. This effect is reinforced because if the avoiders and evaders pay less, the rest have to pay more or face cuts in public expenditure.¹³⁶ The existence of tax evasion could contribute to the further erosion of the tax structures with broader bases and lower rates.¹³⁷

Tackling tax evasion: Fewer tax incentives, development of broader tax bases and lower tax rates and administrative improvements in the area of information, tax collection, and auditing would help make tax evasion both less feasible and less desirable. Much of the attention in this area has been devoted to why some taxpayers do not comply rather than why others do so. The emphasis should be the other way round. The norm is usually to comply rather than not to comply. For a tax system to be effective, the majority of taxpayers must comply with it. It follows that there may be greater gains in assisting compliant taxpayers meet their fiscal obligations than in spending more resources in pursuing the minority of non-compliers.

Many taxpayers might be willing to comply in full but are unable to do so because they are not aware of, or do not understand, their full obligations. Even if such taxpayers understood their obligations, they may not know how to meet them or may be unable to do so for other reasons. Additional expenditure devoted to assisting such taxpayers, for example, for informing or educating them, might yield greater additional revenues than if it were spent on additional enforcement activities. However, it is not advocated that non-compliers must be simply ignored; the already existing penalty and prosecution provisions must be pursued in such cases to their logical ends. Prevention of tax evasion by making compliance less expensive appears to be a more sensible alternative to tackling evasion through such ad-hoc and popular measures as voluntary disclosure schemes.

7. Corporate Tax Reforms

Reform of the corporate tax structure and of its administration is an important area of interest to governments in most countries. It is, therefore, important to understand what actually constitutes tax reforms and know the

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important issues involved in the reform of corporate income-tax and the nature of relationship between tax administration and tax reforms. The expression "tax reforms" is understood usually to mean an exercise aimed at making a tax system fairer and more acceptable to the citizens, making tax laws simpler, removing anomalies, improving compliance with tax laws, strengthening enforcement, improving the income elasticity of tax revenue and making the tax system revenue neutral and equitable. The ways and means of achieving these objectives might differ from country to country, but the basic components of tax reform, in terms of what is desired to be achieved, remain more or less the same.

7.1 Tax Administration and Tax Reforms

Tax reform involves changing both the tax law (what is said) and the administration of the law (what is done). Reform of tax structures is generally more effective when accompanied by improvements in tax administration and strengthening tax administration is one of the most important objectives of tax reform. The experience of countries that have fundamentally changed their tax and trade policies demonstrates that, if these economic reforms are to be successful, there is clearly a need for rapid administrative reform. It is now widely acknowledged that a tax law or a tax policy is only as good as its administration. In tax reform, there is a strict and clear interrelationship between good tax policy and tax administration. Simply, good tax policy cannot exist without good tax administration.

Policy change without administrative change may achieve nothing. Changing tax administration must be looked upon as a means for achieving effective tax reform. Since tax structure and tax administration are interdependent, any tax reform

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effort must take both aspects into account\textsuperscript{141}. As Khalilzadeh-Shirazi and Shah point out, “the success of tax policy changes depends heavily on the administrative ability (and, of course, the political will) to collect revenues through fair and efficient enforcement”\textsuperscript{142}.

Structural and administrative reform must be considered together if tax reform is to accomplish the goals usually attributed to it\textsuperscript{143}. The shape of a tax system in practice is determined to a great extent by the way it is administered; administrative reform must go hand in hand with structural reform\textsuperscript{144}. The key to successful tax reform is to design a tax structure that can be administered adequately with the available resources while at the same time making the best possible use of those resources from a long-term perspective.

Reforms that do not take administrative limits adequately into account are likely to turn out in practice to be quite different from the way they look on paper\textsuperscript{145}. In addition to administrability, political will is also important for the success of tax reforms. As Bird states, “if politically significant groups are dissatisfied with the outcome of the tax system for any reason and consider it unfair, the result may be decreased compliance where taxpayers can get away with it. Decreased taxpayer morale owing to perceived unfairness may thus lead to increased shrinking (evasion)"\textsuperscript{146}. People’s acceptance of government’s expenditure policies and tax administration’s handling of taxpayers are critical for success of reforms and tax enforcement. Without political backing, reforms cannot make any headway, however urgent the need for reforms may be\textsuperscript{147}.

An efficient, non-arbitrary and impartial administration is a pre-requisite for the success of any reform measure. As Asher puts it, “a good tax badly administered is unlikely to attain its objective”\textsuperscript{148}. It is critically important in proposing changes in tax policy to be sure that such changes do not require a higher order of administrative capability than exists. If they do, the changes will either not, in the end, be implemented, or, if implemented, they will in all likelihood fail, or have unforeseen (and often undesired) effects\textsuperscript{149}.

7.2 Issues in Corporate Tax Administration

Some of the major issues that have assumed significance in recent times and which are crucial for the success of a modern tax reform programme include computerization of tax administration, privatization, tax deduction at source, public relations, service conditions of tax personnel, etc. These issues are discussed in the following paragraphs.

7.2.1 Computerization of Tax Administration

Computerization of tax administration offers the most effective means of meeting the additional budgetary needs for revenue, increasing compliance with tax obligations and more efficient collection which are becoming priorities for developing countries\textsuperscript{150}. There are several areas in which tax administration could benefit from computerization. Such areas include processing tax returns and payments, checking the accuracy and consistency of data reported, calculating taxes, identifying computational errors, maintaining taxpayers’ records and general


accounting controls and records, preparing notices, group assessments, issuing of refunds, etc. At minimal cost, automated data processing programs can produce operating and statistical reports designed to assist tax managers and policy makers in management, formulation of tax policy, and economic analysis and research151.

One of the most important of the developments in the technological revolution taking place in information technology is the replacement of paper tax returns with their electronic equivalents. Electronic submission allows tax returns that have been prepared an appropriate software package on computer to be sent to the revenue authorities and processed by them in that form. The initial benefits were seen as increased efficiency and accuracy in the assessment process. For instance, in the United States, the IRS found that the cost of processing an electronically filed return was only three cents - in comparison to the 72.5 cents it cost to process a paper return. It was also found that the error rate in the assessment of electronically filed return was a mere 3 percent, compared to a rate of 17-20 percent on paper returns. Such computerization also has implications for the duties placed on revenue staff. Electronic submission reduces the mundane traditional paper handling procedures and allows staff to spend more time on other activities such as taxpayer support. This in turn has implications for types of revenue staff required, their training, career development and the duties they will be expected to undertake.

Computerization also has major implications for enforcement. Computerized systems can be used to identify defaulters, select returns for audit, and verify data and identify tax evaders through cross-checking with external sources or other computer files. It enables tax authorities to undertake far more sophisticated analyses of information than was previously possible. Although it is true that large claims for tax refunds or deductions and exemptions could always be tackled through tax audit action in the usual way, with the electronic submission of returns it becomes

economical to identify areas where large amounts of taxation are potentially being evaded over many small transactions.

7.2.2 Privatisation of Tax Administration

Privatisation of tax administration does not necessarily mean the whole-sale handing over of tax collection and enforcement functions to private agencies, nor is such a course of action desirable or feasible. What is often suggested is not total privatisation, but the identification of parts of tax administration that can be privatized with proper supervision from public authorities. Levy, collection and enforcement of income-tax is one of the major instruments of public finance and no one means to divest Governments of powers to tax companies. What is sensible and desirable is therefore to privatise certain components of tax administration that is better done by private agencies and that could result in considerable cost-saving for tax administration and realisation of better results.

For instance, printing of statutory and non-statutory forms, management of advertisement campaigns, creation of computerized data base of non-classified information, collection of income-tax returns from assessees, generation of statistical reports, etc., are but a few areas where privatisation could bring in instantaneous and assured improvement. Selective privatisation has also the merit of freeing more time for tax administration for devoting to weightier matters and for concentrating efforts on greater efficiency in assessment, investigation and tax collection areas.

To some limited extent, tax administrations have already tried privatisation, albeit indirectly, through measures such as tax deduction at source, but the term privatisation of tax collection may still appear to be a taboo. Understood in the

above context, privatisation could be a boon to tax administration. Privatisation in the area of tax administration is a more traditional concept than one might think. Tax deduction at source by private employers is one clear examples of participation by the private sector in administration\textsuperscript{153}.

Even in areas where literal privatisation is difficult or impossible, management practices used in the private sector may be implemented by a tax administration. The tax administration should not surrender its ultimate assessment authority, and must carry out performance spot checks. Resorting to private audit as an interim measure may be necessary to move the tax administration in the direction of reform. More aggressive efforts to privatise might consider the concept of return certification or contracting out advance rulings.

The consideration of these options should take note of the fact that fewer responsibilities will enable the tax administration to focus its efforts and do a better job in areas remaining under its control. While some tasks are appropriate for the private sector, there are certain fundamental areas of tax administration such as scrutiny assessments and audit which naturally belong in the public sector. In such areas, privatisation should only be considered as an interim measure to correct serious problems and eventual restoration of such functions to the tax authority is more desirable. Some problems cannot be solved through any sort of privatization because the problem is legal or outside the tax administration (in the courts, for example). In such situations, the only recourse is to push for legal reforms, including establishment of a tax court.

Byrne has advocated a system of advance rulings wherein a panel comprising representatives from tax administration would give advance decisions on issues concerning income-tax implications of major corporate decisions and involvement of private professionals in this practice. He feels it is desirable because “it gives

taxpayers a vehicle to achieve the predictability so important for investment decisions. It is advantageous for the tax authority because more transactions can be monitored at less cost (because of the fee).

Private tax professionals will be more neutral in their analysis (of advance rulings) if they are paid by the tax authority, their work is subject to review and future work is conditioned on satisfactory performance. To implement a privatised advance ruling scheme, it will be necessary to establish a fee schedule for taxpayers, guidelines for format and payment to private contractors, and a review mechanism that protects the tax authority’s interest and creates a history of the contractor’s work to use in deciding whether to employ such contractor in the future”\textsuperscript{154}.

A very eminent suggestion with regard to the privatization comes from Terkper who recommends that tax practitioners be recognized in their efforts and given due place in tax administration that they deserve. He observes that “in even the more sophisticated countries such as the United States, Canada and Australia where literacy rates are high, the success of tax collection and enforcement has been achieved only with the active involvement of tax practitioners who complement the efforts of the administration. It is necessary to outline an official programme in Third World Countries under which practitioners or agents could be registered and their activities supervised by the tax administration and possibly, the professional accounting bodies”\textsuperscript{155}.

\subsection*{7.2.3 Tax Deduction at Source (Withholding)}

Tax deduction at source (or withholding) is a major time-tested method of tax collection throughout the world. Tax administration problems in developing countries can be mitigated to a great extent by extending the scheme of withholding.


over a wide area\textsuperscript{156}. Withholding serves not only as a mechanism for ensuring that tax payments are remitted, but also as an approximation of tax due by the taxpayer\textsuperscript{157}. As Bird has rightly observed, "tax systems depend more upon taking money away from people before it gets into their hands- and scaring them into paying the balance- than they do on goodwill"\textsuperscript{158}. Tax administration can benefit by improving the implementation of withholding provisions.

### 7.2.3 Public Relations

Several economists\textsuperscript{159} have pointed to the great need for tax administrations to improve their public relations. Organizational structure should be so arranged that taxpayers' issues or problems can be resolved through a single point of contact, there is increased cooperation with state, local and foreign governments, more assistance for small businesses to help them comply, more 'preventive' education for public, increased awareness of tax responsibilities in schools and recognition of the need to devise ways (not necessarily monetary) to recognize compliant behavior and to reward those who submit tax returns and pay their tax on time.

A more organized approach to influence legislation is needed and the revenue service must become a taxpayers' advocate in the legislature for simplification and fairness. There should be better publicity about how the tax system works, how taxpayers benefit by complying and how the tax administration deals with abuses of the system\textsuperscript{160}. Improving public relations is necessary because the public's perception


of a tax administration’s integrity, efficiency and effectiveness directly affects the citizens’ willingness to voluntarily comply with the tax laws. 161

7.2.4 Service Conditions of Tax Personnel

Economists are unanimous in recommending that tax administrations must be made autonomous both financially and functionally, that tax administrations should not be treated as just another appendage of the general civil service of countries and that service conditions of tax personnel need to be greatly improved so as to infuse in them professionalism and attract the best of talents. Modernization and greater professionalism could be promoted in tax administration by making the tax administration autonomous, with its own, pay scale and standards. Noting that the tax administration is often over-staffed with incompetent personnel as a result of which low performance standards combine with low salaries to make corruption almost inevitable, Byrne cites the example of many developing countries where dramatic revenue growth has been registered by increasing pay to attract more qualified tax administration employees. 162

The status of revenue institutions in the public sector is one of the major factors affecting their inability to specialize and respond adequately to changes in the economy. The resources needed for the effective operations of these institutions are denied primarily because the institutions must compete for funds in ways which do not excite ill-feeling among other government departments in the service. The inclusion of the revenue institutions in the civil service results in monetary and financial institutions in the economy enjoying a more substantial measure of operational autonomy than fiscal institutions. This policy has adverse consequences on the efficiency of tax administration in many countries.

A serious impediment to change in the tax administration is that revenue institutions have traditionally been part of the general civil service. This has resulted in salaries that are too low to recruit and retain the quality of skills needed for the efficient operation of a revenue system. When one compares various central banks with the tax administration in their respective countries it is clear that the banks operate with greater efficiency and effectiveness. The banks are most often looked upon by employees as the best place to work in the public sector. There are several reasons for this. First, the pay is usually higher. Second, employees usually receive better training. Third, the office equipment is much better and more modern. Fourth, the working conditions (physical facilities) are usually substantially better.

Poor package of pay and allowances hardly commensurate with risks and responsibilities of officers apart, there are much more important issues connected with the security of the tax personnel, as evidenced by the recent spurt across the country in violent attacks on personnel engaged in field operations such as surveys and search and seizure who face tremendous and grave threats to their very lives. Added to this problem is the widespread dissatisfaction among the rank and file of tax administration about the lack of career advancement opportunities and the overlooking of the largest organised cadre of specialist civil servants in the country in appointments to highest positions in the country's civil service, even where such positions are clearly within their own areas of competence and specialization. Needless to say, the success of any reform package crucially depends upon administrative capabilities to translate policies into reality and this cannot be expected out of a frustrated and poorly paid tax personnel. It is necessary to provide the tax administration with the ability to pay competitive salaries for the skills required, and to change its administrative procedures so that it can operate efficiently and effectively.

There has there been no systematic analysis of the optimal way to reward tax officials, although this subject cries out for study owing to the universality of the
problems arising from the low salaries paid to tax officials. The issue facing most tax administrations is their inability to compete for the scarce physical and human resources available in the economy. The policy focus ought to be on developing a cadre of tax administrators and practitioners and not on overemphasizing the need for an entire population literate in accounting and record-keeping practices. Given the right employment and working conditions, the tax administration could employ qualified personnel to improve its efficiency. The Chelliah Committee recommended a scheme of monetary rewards and out-of-turn for personnel turning out outstanding work performance, but no such schemes have been introduced as yet.

7.3 Tax Reforms in India

Tax reforms began in free India with the appointment of the Taxation Enquiry Committee (TEC) headed by Professor John Matthai in 1953-54. Immediately after the TEC submitted its report, Professor Nicholas Kaldor was invited in 1956 to suggest tax reforms and levies to augment government revenue. This was followed by the appointment of Direct Taxes Administration Committee (Tyagi Committee) in 1958 to suggest a scheme of integration of direct taxes, to prevent tax evasion and to reduce inconvenience to the taxpayers. A Committee on Rationalization and Simplification of the Tax Structure (Bhoothalingam Committee) was appointed in 1967. This was followed by the Direct Taxes Enquiry Committee in 1971 (the Wanchoo Committee) to suggest measures to reform direct taxes and to curb the problem of tax evasion. Then, the Direct Tax Laws Committee (Choksi Committee) was appointed to recommend measures to (i) simplify and rationalize the tax laws, and (ii) to improve the implementation of the laws.

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Although so much of efforts have gone into tax reforms and volumes of recommendations and suggestions have been made by so many Committees and experts, anomalies of the tax system have continued to grow. Tax evasion and tax evaders have continued to thrive. Distribution of tax burden has become more inequitable and problems of tax administration have compounded. Many of the problems of the 1980s (such as the growing gap between revenue and expenditure of governments and the damage caused to the economy by an inefficient tax system and widespread evasion) still persist.

Against this backdrop, the Tax Reforms Committee (popularly known as Chelliah Committee) was appointed in August 1991 to examine the structure of direct and indirect taxes and to suggest measures (i) to improve the elasticity of the tax revenue; (ii) to make the tax system fairer and broad based; (iii) to rationalize the system of direct taxes with a view to removing their anomalies, improving equity and sustaining economic incentives; (iv) to identify new areas of taxation, (v) to improve compliance of direct taxes and strengthen enforcement; (vi) to simplify and rationalize customs and to reduce tariff rates so as to improve international competitiveness of Indian exports; and (vii) to simplify and rationalize the structure of excise duties for better tax compliance and administration and to widen the scope of Modvat Scheme.

The Chelliah Committee submitted its Interim Report in December 1991 and its Final Report in August 1992. Emphasizing the need for reforming the country’s tax system, the Committee drew attention towards the alarming scale of tax evasion in India and attributed the same to high tax rates, complex procedure of tax compliance, legal complexity leading to prolonged litigation, and, on top of

\[168\text{Ibid, p. 175.}\]
everything, administrative lapses, inefficiency, corruption and nexus between influential tax evaders and political elements.

The guiding principles of tax reform as adopted by the Chelliah Committee were that: "(i) the tax system and its burden must be acceptable to the citizens, (ii) compared to the existing system, it is better to have moderate rates with broader bases, (iii) while tax structure should be progressive, it should not be such as to induce the generation of unaccounted incomes and wealth, (iv) tax structure must remain stable unless and until the economic conditions undergo a radical transformation, (v) the tax system and law should be as simple as possible; it should have limited number of rates, exemptions and deductions and the law should not be interpretable in different ways, and (vii) tax reforms should be revenue neutral and income elastic."\textsuperscript{171}

The Chelliah Committee felt that phasing out many of the fiscal concessions and having more uniform statutory rates across various types of businesses would be desirable on efficiency as well as administrative considerations. The Government’s objective should be one of evolving a simple and stable tax regime with reasonable tax rates but stricter enforcement. The required additional revenues have to be generated by a judicious mixture of broadening the tax base, rationalizing the tax rates and through non-tax sources. The Committee therefore called for an overall simplification and rationalization of the tax system that would help not only in broadening the tax base but also in providing a simple and rational incentive structure which would be conducive to an efficient growth of the industrial sector.\textsuperscript{172} Following the publication of the Chelliah Committee’s reports, the Government of India began the latest round of tax reforms the year 1991-92.

8. International Trends in Corporate Tax Reforms

*Developed Countries:* The dominant theme in worldwide income tax reform has been to lower the corporate tax rates and to broaden the tax base\(^{173}\). In the advanced countries the main thrust of tax reforms has been to cut corporate tax rates and withdraw tax incentives for investment\(^{174}\). The UK led the way in reducing corporate income-tax rates. In 1984 it reduced the rate from 50% to 35% and compensated the revenue losses arising out of the rate reduction by eliminating deductions allowed for investments on plant and equipment. The Inland Revenue in the United Kingdom has been testing the electronic submission of Corporation Tax Returns and this could be extended to individual’s return from 1997 under the new self-assessment arrangements\(^{175}\).

Canada has also eliminated its investment tax credit (except for some regional credits) and reduced its federal-provincial corporate rate from 51% to 44% (39% for manufacturing corporations). Corporate tax rate cuts are also being made in the Netherlands and Japan.

Denmark has increased its corporate tax from 40% to 50%, but a new tax credit for dividends was introduced in 1990\(^{176}\). In Australia, the corporate tax rate was raised from 46% to 49% in 1987, reduced to 39% in 1989 and an imputation system was introduced for the corporate dividends. Consideration is now being given to broadening the tax base with a view to further reducing the corporate rate\(^{177}\).


\(^{176}\)Ibid, p. 201.

In France, the corporate tax rate on retained earnings was cut from 50% to 39% beginning in 1989 and to 34% in 1993. Since the tax credit for dividends has not been changed, this reduction in the corporate rate automatically reduces the double taxation of dividends\textsuperscript{178}. In Germany, the tax rate on retained profits of corporations has been reduced from 56% to 50%. In Italy, there has been a speed up in the collection of corporation taxes, but corporate income tax rates have remained unchanged. In Sweden, the corporate tax rate has remained at 52\%\textsuperscript{179}.

The U.S. tax reform in 1986 eliminated the partial exemption of capital gains income, disallowed the deductibility of some state and local taxes, ended the investment tax credit, slowed depreciation of buildings, and introduced a host of other provisions designed to keep total personal plus corporate income tax revenues unchanged as rates were reduced. Lower income tax rates and broader base were introduced in order to make the tax system more neutral with respect to economic decisions\textsuperscript{180}. Federal corporate tax rate was reduced from 46\% to 34\%. The corporate and individual income tax rate reductions became fully effective at the beginning of 1988\textsuperscript{181}. The Internal Revenue Service (IRS) in the United states was one of the first to introduce an Electronic Return Filing System. The System is used by professional tax prepares for tax payers claiming refunds (Internal Revenue Service, 1988). By 1991 over seven million income tax returns were being filed electronically.

In Japan, the corporate income tax has been reduced from 55\% to 37.5\%. The Japanese tax administration has introduced a self-assessment system for corporations to ensure that all taxpayers understand the importance of taxation and submitted returns and paid their correct tax liabilities voluntarily. To achieve this, it

has sets out a policy of establishing an environment which encourages taxpayers to submit proper returns and pay taxes voluntarily. This includes communication with taxpayers through public relations, general guidance and consultations. In tax audits, one of the aims is also to use the opportunity to improve taxpayers' understanding of the tax system and to facilitate voluntary compliance. The tax administration also aims to develop self-disciplined and efficient officers with good human relations, to ensure correct assessments and enforcement action as necessary. The Japanese tax administration recognizes that, to improve voluntary compliance on the part of taxpayers, the revenue authorities should act in a fair and impartial way and their work should be disciplined, cheerful and efficient\textsuperscript{182}.

The Australian Tax Office implemented an Electronic Lodgement Service on a national basis in 1990. Just over half of Australian tax returns were submitted electronically by 1991-92 and by 1992-93 the figure was almost 60 percent. To identify abnormal features in electronically filed income-tax returns, Australia introduced a scheme called KATE (Key Abnormal Tax Agent Evaluation). The KATE system allows the revenue service to identify tax agents (tax representatives or consultants) with clients’ returns that vary significantly from the average of those of other agents in the same region. The KATE system is used to pick out those tax agents whose clients claim work expenses above the average. If there is no obvious explanation, such agents and clients may be subject to closer investigation.

Most of the developed countries have attempted to integrate their individual and corporate income taxes by providing some form of dividend relief. The exceptions are Sweden, the Netherlands, and the US, which use the classical system of separate corporate and individual income taxes. However, Sweden now provides a 10% deduction at the corporate level for dividends paid on new capital issues for a period of 20 years. Australia recently enacted an imputation system along the lines adopted by France, Germany, Italy and the UK. Denmark plans to introduce

imputation in 1990. In enacting its 1986 reform, the US Congress rejected a proposal by the administration to reduce the corporate tax on distributed earnings\textsuperscript{183}.

\textit{Developing Countries:} In developing countries, heavy reliance on indirect taxes of various kinds coupled with steeply progressive direct taxes with exemptions and preferences have made the tax system extremely complex and harmful to the growth of the economy\textsuperscript{184}. The existing tax systems of many developing countries are distortionary and contribute to a host of economic problems, including production inefficiency, capital flight, and fiscal and balance of payments disequilibria\textsuperscript{185}.

The developing countries, like the advanced ones, have been trying to move towards a broad based, low-rate regime of personal and corporate income taxes. Many have tried to align the corporate rates to the top bracket personal rate, facilitating integration of the two. Rate reduction has proceeded with broadening of the income tax base by weeding out incentives, pruning the deductions and exemptions, tighter taxation of fringe benefits, introduction of presumptive taxation, etc.\textsuperscript{186}.

\textsuperscript{186}Bagchi, A. (1991b): \textit{Ibid.}. 