

**CORPORATE TAXATION IN INDIA :
IMPACT ON CORPORATE PROFITS,
SAVINGS AND INVESTMENT**

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INTRODUCTION

India is supposed to be a highly taxed nation, so far as direct personal taxation and taxation of corporate income are concerned. Naturally, it is argued that the high rate of corporation income tax in our country must have adverse effects on the corporate income after tax, saving, investment, ploughing back of profits, capital structure and their policies of dividend distribution.

Corporations in India are subject to company tax at a flat rate under the Indian Income Tax legislation. However, the rates of company taxes are discriminatory in character, viz., private companies and closely-held companies are charged a higher rate as compared to public limited companies or widely-held companies. Domestic companies receive favourable treatment vis-a-vis foreign companies and foreign collaborations. There is a general consensus in the private sector and among economists that the rates of company tax for different types of corporations are relatively higher. In a developing country of the third world like ours, where rapid industrialization and shifting of surplus manpower from agriculture to industries and tertiary sector is the need of the hour, it is not desirable to have heavy taxation of corporate income. It is argued that such taxation would lead to a decline in corporate

saving and investment. It may also have an important impact on the capital structure of the corporations.

Every Finance Bill brings about some changes in the allowable deductions or in the incentives for investment. The method of allowable deduction for depreciation, investment allowance, development rebate, allowable business expenses and entertainment expenses, etc., is changed from time to time. These changes do have certain impact on tax base and tax revenue of the Government. A shift from risk capital to borrowed capital or vice-versa is possible due to a number of factors. Even the flat company tax rate is sometimes changed. Any change either in the tax base or tax rates leads to a greater change in the effective tax rate (explained in Chapter 2 of this work) which may affect companies working under different sets of conditions differently. For instance, if the business prospects of a company are bright, it can raise more borrowed capital, pay out fixed interest liabilities and make a handsome income for distribution of attractive dividends. But if the venture is a new one and its future is uncertain, companies do not prefer to have borrowed capital. Where the expected rate of profit before tax is low, companies prefer maximum ownership capital because they find it difficult to raise borrowed capital through issue of debentures, public deposits or bank borrowings.

Interest liability on borrowed capital is an allowable

deduction from income for computing taxable income whereas the dividend payment is not. Therefore, interest income of the creditors is subject to single taxation in their own hands whereas dividend income of the shareholders is subject to double taxation. Firstly, at source of company's profit before dividend distribution and secondly, on the dividend income as a source of personal income of the individual shareholder. Some economists argue that double taxation of corporate income has a discouraging effect on public responses to issue of shares by companies. The business corporations in the private sector, particularly with new and risky ventures, generally find it difficult to list their securities at the stock exchanges. Thus, any change in the rate of corporation tax, allowances and deductions affect the market prices of securities at the stock exchanges.

Thus, the corporate tax structure may have widespread effects on profitability of business corporations, their saving, investment, capital structure and policies of dividend distribution, capacity utilization, etc. This topic has been chosen for M.Phil. dissertation with the following objectives.

Objectives

- 1) To examine the rates of Corporation Income Tax for the period from 1970-71 to 1989-90 introduced by the Finance Acts from time to time;
- 2) To assess the utility of various tax concessions, allowable deductions, and incentives for savings and investment by the business corporations;

- 3) To examine the impact of corporation tax on the savings, investment, capital structure of the corporations and on overall growth of business corporations; and
- 4) To assess the revenue elasticity and effective tax rate of the corporation income tax.

Statement of Hypotheses

The study of corporation income tax in India and its impact on the Indian economy was undertaken with following hypotheses.

- 1) India's rate of corporation income tax is high and as such there is scope for downward revision of the tax rate;
- 2) Corporation income tax in India adversely affects profits after tax, saving, investment and capital structure of business corporations; and
- 3) Discriminatory tax treatment for closely-held domestic companies and foreign companies has a positive effect on the growth of domestic and widely-held companies.

Methodology and Scheme of Chapterization

The study covers the period from 1970-71 to 1989-90 and is based on available literature on the topic and secondary data from RBI Bulletins, Currency and Finance Reports of the RBI and a number of scholarly articles

appearing in different journals and newspapers. Each and every borrowed material is duly acknowledged. Since Corporation Tax is the revenue item of the Union Government, the data about tax collection, share of corporation tax in the total tax revenue, in the direct taxes and Corporation Tax as per cent of National income pertain to the whole country. Statewise break-up was not attempted in this work. In a way, it is a humble attempt to present existing literature on the topic in a systematic manner with a view to bring about some useful conclusions.

This dissertation is planned into five chapters as detailed below:

- (1) Corporate Personality.
- (2) Structure of Corporation Income Tax in India.
- (3) Deductions and Allowances.
- (4) Impact of Corporation Income Tax on Indian Corporate Savings, Investment, Capital Structure and Employment.
- (5) Summary, Findings and Suggestions.

Limitations of Study

The work is based on secondary data that is available from published literature some of which was discontinued due to changes in classification of certain items. A greater degree of accuracy would have been obtained had appropriate and continuous series of information been available.

CHAPTER 1

CORPORATE PERSONALITY

"All this is to suggest not that the corporation cannot be touched but that to touch the corporation deeply is to touch much else."

- Edward Mason

1.1 Concept of a Corporation

Corporation or more precisely a business corporation is "a form of organisation which enables a group of individuals to act under a common name in carrying one or more related enterprises, holding and managing property and distributing the profits or beneficial interests in such enterprises or property among the associates ... its shares are transferable; its life independent of lives of the individuals; its debts do not usually create a liability for latter."¹ This is not a mere definition of a corporation but almost a complete description of that type of business organization. Thus a corporation is a voluntary association of a group of persons who pool their resources and undertake some type of business or trading activity. The express purpose for this is, of course, to make profits. The most important benefit of this type of business organization is the principle of limited liability—liability limited to the holding of shares by an individual. It is for this reason

that the corporate form of business organization has become very much popular all over the world in various economies. However, unlike a partnership or a sole proprietorship, a corporation is distinct from the individuals who may own it. Owners may die or they may sell their ownership, but the corporation goes on.

Another definition of corporation is given by Chief Justice Marshall: "A corporation is an artificial being, invisible, intangible and existing only in contemplation of the law."² Being the mere creature of law, it possesses only those properties which the charter of its creation confers upon it, either expressly or as incidental to its very existence. These are, such as are supposed best calculated to effect the object for which it is created. Among the most important are immortality, and if the expression may be allowed, individuality, properties by which a perpetual succession of many persons is considered as the same and may act as a single individual. They enable a corporation to manage its own affairs and to hold property without the perplexing intricacies, the hazardous and endless necessity of perpetual conveyance for the purpose of transmitting it from hand to hand. It is chiefly for the purpose of clothing bodies of men in succession with these qualities and capacities that corporations were invented and are in use. "By these means, a perpetual succession of individuals are capable of acting for the promotion of the

particular object like one immortal thing."³ Immortality means a perpetual succession of many persons who "may act as a single individual".⁴ A perpetual succession of individuals is capable of acting for the promotion of a particular object like one immortal thing. A corporation, therefore, will not die or it will not be dissolved, when a stockholder withdraws his interests "as happens when a member of a partnership withdraws. Although the stockholders may change, the identity of the corporation remains intact."⁵ This gives stability and longevity to the corporate form of business organization. So Mason says "the corporation recruit our youth from college and provides them with pensions in their old age".⁶ Therefore, a corporation can have long-term plan to execute its business policy. It is so thoroughly integrated into the business culture, that "to suggest a drastic change in the scope or character of corporate activity is to suggest a drastic alteration in the structure of society,"⁷ especially in an industrialized economy.

Irrespective of these traditional meanings, there are some modern conceptual discussions about the dynamic nature of a corporation, e.g., corporations are 'inevitable in industrial society and necessary in underdeveloped society'⁸ as they feed technological needs and huge capital requirements in industrial development. Therefore it is a necessary evil in a developing economy, and it has "co-existence with

men"⁹ for increasing the production, consumption as well as living standard of the society. It increases the overall rate of growth and is related to ethical and social values too. Some corporations are operating in other countries, not merely on financial motives, e.g., investing funds and selling goods but they have to operate with corporate managerial responsibility and to live under the laws and customs of other countries.¹⁰ The responsibility to increase the profit and reputation of the corporation in all fields and areas rests with corporate management. Therefore "on the one hand we hear much talk of 'a new feudalism' of 'self-perpetuating oligarchies' or 'irresponsible private power' and of the euthanasia of the capitalist owner".¹¹ But on the other, we are told of 'the twentieth-century revolution', the 'professionalization of management', the various public whose interests are sedulously cared for and the beneficence of the 'corporate conscience'. It is not to be wondered that to date, this cacophony of voices has "not produced a very firm view what to do about the corporation either in the general public or the minds of legislators".¹² In this connection, what Mr. Berle is afraid of is that "this powerful corporate machine, which so successfully grinds out the goods we want seems to be running without any discernible controls".¹³ They are big enterprises in corporate form. They are repositories of power, the biggest centres of non-governmental power in any

society. They have the ability to control the price and quality of products made and offered for sale and power to concentrate economic resources in a particular industry. Apart from buying and selling the product, they have to manage wage rates, working conditions and other terms of labour. So, large corporations can influence economy as a whole to a great extent. They are chief agencies of private research. They become leading purveyors of influence and pressure on public officials in the country or society. Therefore, they bear large responsibility. In short, a corporation is an institutional device for large scale organization of energies and resources and technical efficiency; as such, they become centres of significant non-governmental power within the society. It can be turned into "professional imperialism".¹⁴ The role of government in such an economy persistently increases. "The main theme is that the relationship of the corporate sector to the society has become more complex, or at least that the complexities are becoming more recognised. This, it is said, offers new opportunities for the exercise of corporate power and poses new difficulties for its control."¹⁵

1.2 Corporate Objectives

The objectives and policies of the modern corporation are necessarily complex. They reflect the interests and pressures of various groups or classes of persons involved in the affairs of the corporation. Each of the groups tries

to exert a strong influence on corporate policies, though each of it may not be equally strong.

Generally speaking, the basic traditional objective of a corporation is maximization of profit. Shareholders would be keen on getting a handsome reward by way of dividend on their shares. The shareholders "collectively are in a position to control the company's basic policy and direct it towards the maximisation of their welfare as a group subject to the constraints arising from the pressures exerted, from time to time, by the other interested group".¹⁶ Traditionally, maximization of business profits and incentives connected with it have been thought to constitute an essential part of the justification of a private enterprise system. In recent times, managerial attitude seems to have shifted from profit motive to other social objectives. Managerial voices are raised to deny the exclusive pre-occupation with profits and to assert that corporate managements are really concerned with equitable sharing of corporate gains among owners, workers, suppliers, and customers. "If equity rather than profit is the corporate objective, one of the traditional distinctions between the private and public sector disappears."¹⁷ Many economists have pointed out other possible goals. "Making money for shareholders as the method of achieving the most economic provision of goods and services to the society ... no longer receives respect as an adequate statement of business

objectives."¹⁸ Non-profit maximization objectives include contentment with a 'satisfactory' profit rate, 'normal' dividends or a 'just' price; the desire for a high value of assets, sales, output, market share or rate of growth. If equity, rather than profit maximization, is the primary consideration, it may be asked why duly constituted public authority or a public sector enterprise is not an equally good instrument for dispensing equity as self-perpetuating corporate managements? Corporations in private sector work exclusively in business area which is not the case with public sector enterprises. As such, performance or efficiency of operations is susceptible to measuring rod of money in the case of private corporations which make them profit-conscious regardless of secondary non-profit maximization objectives expected to be achieved under "social responsibilities of business".¹⁹

Whatever may be the objective belonging to the above-mentioned categories, "it is evident that a business cannot survive too long without meeting its total cost of production ... when any of the aforesaid objectives govern the goal of the firm, there exists a possibility for complete or partial shifting of corporation tax".²⁰ Effort to shift tax is likely to be more when profit maximization is the only objective of the firm, as the tax liability reduces profit after tax in the hands of corporation for distribution of dividends.

1.3 Features of the Corporate Personality

The principle of limited liability has been mainly responsible for the growth of the corporate sector. Whenever a corporation is formed, its assets cease to be the property of any individual. "If a person owns a few shares of a corporation, he has right over the corporation and duties towards it only to the extent proportionate to his possession of those shares."²¹ A large number of individuals, by virtue of their share holdings, can jointly own a corporation; but they can claim individual ownership of only a small fraction of the whole. This is because a corporation is a separate 'artificial' or 'fictitious' entity created by the law of the land. A corporation is just like any other individual person which can sue or can be sued by any other individual for the claims to be received or to be paid. In this artificial legal form, the corporation is entitled to be treated as if it were a person in the eyes of the law. A corporation has a right to purchase and sell property and to prosecute and defend itself in a court of law, just like an ordinary human being.

But though it is a person in legal sense it is distinct from its shareholders, managers or employees. The corporation has a perpetual existence. An owner of a company i.e. shareholder, may sell his shares to another person or transfer them to his legal heirs; such transfer of ownership of shares does not affect the existence of

company. It can only cease to exist if the people who own its shares will take necessary legal step to liquidate the company. A company is, therefore, compared with a river because just as the river is the same river "though the parts which compose it are changing every instant",²² a corporation is also the same though the people who own it may change from time to time. Though a corporation is a legal and 'fictitious person', it is subject to certain limitations of actions.

(1) Though a corporation is a person in the eyes of law and enjoys certain rights and discharges certain duties, it is not capable of all those legal relationships open to natural persons.

A corporation may not marry or make a will, though it is true that for a vast number of legal situations, "it makes no difference whether the relationship involves two corporations, a corporation and a man or merely two men; the legal principle is the same".²³ The taxable income of a company is determined in the same manner as that of an individual. According to sovereignty theory, if a company is regarded legally as a fictitious person, it means corporations exist because the state authorized their existence.

(2) Another view holds that the corporate personality is a shorthand expression to convey certain attributes of this association of persons. For example, from the commercial point of view, it is specified that the personal liability

of the members is limited to their shareholding; and from legal point of view, actions can be taken only against the corporation as a whole and not against any individual shareholder.

According to Norman S. Buchanan "Corporation is a financial and accounting unit; that is to say, it is a unit for the purpose of computing cost and measuring income. Indeed, in terms of social consequences, the significance of the corporation as a unit for computing costs and income doubtless exceeds the limited liability feature."²⁴

From the various explanations about the corporate personality discussed above, it will be seen that the corporate personality is similar to and distinct from the individual personality at one and the same time; just as the individual earns income and pays taxes, the corporation also earns and pays taxes. However, an individual is a complex of emotional and other reactions which the corporation cannot be.

A distinguishing feature of a modern corporation is the separation of ownership and control.²⁵ Actual owners are shareholders but the real power is vested in the hands of the paid executives. In such a situation, the owners are necessarily relegated to the position of mere money-lenders of the corporations with added risk of losing the principal itself. "The principle of limited liability seems to attract vast funds from the common man by way of share capital,

because the obligation of individual shareholders for the debts or liabilities which the corporation may incur, is limited to a specified amount, usually, the amount of money the shareholder has invested in the concern by purchasing shares." Investors in losing enterprises lose only their investment (in shares) and not their other assets or wealth.²⁶ But such an ownership is available at a loss of effective control on the corporation because of "the widespread distribution of shares among millions of individual investors, the pattern of non-interference and almost automatic support of management on the part of institutional investors, management control of the proxy solicitation machinery and the absence of an organized party system around which institutionalized opposition to management may organize".²⁷ In short, because of limited liability the shareholders become passive about the control and because of the managerial responsibility, managers become powerful and expert. Therefore this typical situation has an important connection with the tax policy of the state. A tax on corporate income, because of the divergence of ownership and control can be justified on two grounds. Firstly, there is no reason for merely inflating the returns to the management by way of leaving them with larger amounts of disposable profits. Secondly, shareholders who do not take active interest in the management and control of the corporations are nothing but merely sleeping partners in sharing the profits of the

enterprise. They should be given returns on their shares just necessary to attract their saving. Whatever excess of returns may be available can be taken away by way of corporation tax, so that net disposable income in the hands of shareholders is just sufficient to satisfy them.

1.4 Classification of Indian Companies

Indian companies or corporations are classified in different ways for a variety of purposes. All organizations that qualify as corporations, however, are not treated alike. For the purpose of Income Tax, the division is not only restricted to simple private and public corporations, but is also based upon the residential status of the companies as (i) domestic or residential companies and (ii) foreign or non-residential companies. A residential company is one which satisfies one of the following characteristics:

- (i) It has to be an Indian company; or
- (ii) It is to be a company in which management and control is wholly in India.

"Domestic Company" means an Indian Company, or any other company which, in respect of its income liable to tax under this Act, has made the prescribed arrangements (rule 27) for declaration and payment, within India, of the dividends (including dividends on preference shares) payable out of such income.²⁸ Accordingly, an Indian company is necessarily a 'Domestic' or 'Residential' company.

Similarly, even though a company is non-resident because of the fact that it is registered in a foreign country, it will be a resident company if its head office is located in India. Thus, location of control and management is one important criterion of a resident company. The location of control and management is the place where the meetings of the board of directors are usually held. If such meetings are held in India, the company is a resident one; if not, it is a non-resident company. Corporations do have residential status just like an individual person.

The domestic or resident companies, in turn, are classified into two major categories; first, corporations in which "public are substantially interested" and second, corporations in which the "public are not substantially interested". These groups are also referred to as 'widely-held' and 'closely-held' corporations, respectively.²⁹

Among resident companies, the companies in which "the public are substantially interested", commonly known as public limited companies, must satisfy the following conditions.

The definition of a "company in which public are substantially interested" has been modified in the Income Tax Act, 1961 (43 of 1961) under section 2(18) as detailed below.

"A company is said to be a company in which public are substantially interested -

- I[(a) if it is a company owned by the Government or Reserve Bank of India or in which not less than forty percent of the shares are held (whether singly or taken together) by the Government or the Reserve Bank of India or a corporation owned by Bank;"³⁰ or)
- II[(a) "(a) if it is a company which is registered under section 25 of the Companies Act, 1956;"³¹ or]
- [(a) (b) if it is a company having no share capital and if having regard to its objects, the nature and composition of its membership and other relevant considerations, it is declared by the order of the Board to be a company in which the public are substantially interested;]
- Provided that such company shall be deemed to be a company in which the public are substantially interested only for such assessment year or assessment years (whether commencing before 1st day of April, 1971 or on or after that date) as may be specified in the declaration; or]
- III[(b) "if it is a company which is not a private company as defined in the Companies Act, 1956 and the conditions specified in item (A) or in item (B) are fulfilled,"³² namely :-

- (A) Shares in the company (not being shares entitled to a fixed rate of dividend whether with or without a further right to participate in profits) were, as on the last day of the relevant previous year, listed in a recognised stock exchange in India in accordance with the Securities Contracts (Regulation) Act, 1956, and any rule made thereunder;
- (B) (i) shares in the company (not being shares being entitled to a fixed rate of dividend whether with or without further right to participate in profits) carrying not less than fifty per cent of the voting power have been allotted unconditionally to, or acquired unconditionally by and were throughout the relevant previous year beneficially held by -
- (a) the Government, or
 - (b) a corporation established by a Central, State or Provincial Act, or
 - (c) any company to which this clause applies or any subsidiary company fulfils the conditions laid down in clause (b) of section 108 (hereinafter in this clause referred to as the subsidiary company), or
 - (d) the public (not being a director, or a company to which this clause does not apply);
- (ii) the said shares were, during the relevant previous year, freely transferable by the holder to the other members of the public; and

(iii) the affairs of the company, or the shares carrying more than fifty per cent of its total voting power were at no time during the relevant previous year, controlled or held by five or less persons.³³

In computing the number of five or less persons, the explanatory notes and further that the Government of any corporation established by the Central and/or State Government as well as a subsidiary company of such company shall not be taken into account. Similarly, persons who are relatives of one another and persons who are nominees of other persons shall be treated as single persons.

In case of an Indian company, engaged in the business of construction of ships or in mining or in the generation and distribution of electricity, or other form of power, not less than forty per cent of the voting power has to be held by (a) the Government or (b) a company established by the Government or (c) a subsidiary company or (d) the public (not being director), if it is to be a company in which public are substantially interested. In such companies not more than sixty per cent of its voting power should be controlled by 5 or less persons.

In general, tax treatment differs in respect of different categories of corporations. For example, foreign companies are subject to higher tax-rates, among the domestic companies, 'closely held' companies are charged at higher

rates. The Indian Income Tax Law provides some tax relief to small companies on the basis of size of net profits.

There is a close relationship between the corporate personality and responses of the corporations to the corporation income tax. This relationship is distinct from that of individual personality and responses of the individuals to personal income tax. Though corporation income tax is a direct tax, its impact is not directly felt by the owners because of the divergence of ownership and control in corporations. Individual shareholders are least involved in the management of corporations. Their role is just like a sleeping partner in the business and their interest is limited to their investment in the shares and dividend income. So long as they continue to receive dividends, they are least concerned with the effective rate of corporation tax. Resistance to increase in the corporation tax rate or reduction in tax concessions is therefore almost absent or negligible among the corporations. In this respect, corporation tax appears to be more like an indirect tax. Corporate personality, in itself, is likely to be indifferent to the changes in the corporate tax provisions. It is, therefore, difficult to measure the impact and effects of corporation income tax unlike the tax on personal income. Impersonal management of business corporations may lead to different reactions through savings, investment, level of output and employment than those of sole proprietorship and partnership enterprises.

Notes and References

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CHAPTER 2

STRUCTURE OF CORPORATION INCOME TAX

2.1 Introduction

The corporate tax structure in India is discussed in the present chapter, viz., rationale and need for a tax on income of corporations, the base for such a tax, the concept of corporate income, the rate structure of corporation income tax with changes introduced from time to time through various Finance Acts, etc. Eminent scholars like S.Ambirajan, Ved P. Gandhi, James Cutt, V.D. Lall, Gurucharan Laumas and V.G. Rao have studied the problem by choosing different earlier time periods. I shall, therefore, discuss the Corporate income-tax structure choosing a recent period - from 1970-71 to 1989-90 - mostly by using secondary data.

Table 2.1 shows that corporation tax alone constituted between 40 and 56 per cent of the total direct taxes of the Union Government. Similarly Table 2.2 shows that share of corporation tax in total gross collection of Union tax revenue was between 11.45 and 15.7 per cent during the period under review.

2.2 Tax-Base

Collection of revenue and burden of a tax depends upon the tax-base and rate structure of the tax. The base

Table 2.1 : Share of Corporation Tax in Direct Tax Receipts (Gross) of the Government of India, 1970-71 to 1989-90

Year	Direct Taxes of the Government of India				Corporation Tax as Per Cent of	
	Taxes on Income other than Corporation Tax	Corporation Tax	Taxes on Property and Capital Transactions	Total Direct Taxes	Taxes on Income [3/(2+3) x 100]	Total Direct Taxes [3/5 x 100]
1	2	3	4	5	6	7
1970-71	473	371	26	870	43.95	42.64
1971-72	537	472	38	1047	46.78	45.08
1972-73	630	558	50	1238	46.97	45.07
1973-74	745	583	51	1379	43.90	42.28
1974-75	874	710	66	1650	44.82	43.03
1975-76	1214	862	129	2205	41.52	39.09
1976-77	1194	984	150	2328	45.18	42.27
1977-78	1002	1221	183	2406	54.93	50.75
1978-79	1177	1252	99	2528	51.54	49.52
1979-80	1340	1392	86	2818	50.95	49.40
1980-81	1506	1311	181	2998	46.53	43.73
1981-82	1476	1970	102	3548	57.16	55.52
1982-83	1570	2185	116	3871	58.18	56.44
1983-84	1699	2493	305	4497	59.47	55.43
1984-85	1928	2556	310	4794	57.00	53.31
1985-86	2509	2865	252	5626	53.31	50.92
1986-87	2878	3160	188	6226	52.33	50.75
1987-88	3187	3433	126	6746	51.85	50.88
1988-89	4237	4407	189	8833	50.98	49.89
1989-90 (R.E.)	4257	4755	249	10004	52.88	47.53

Sources: 1) Eastern Economist, Budget Number, Vol.78, No. 11, March 19, 1982, pp. 769-770.
 2) RBI. Report on Currency and Finance, Vol.II, 1986-87, p. 106.
 3) RBI. Report on Currency and Finance, Vol.II, 1989-90, p. 122.

Table 2.2 : Share of Corporation Tax in Total Tax Receipts (Gross) of the Government of India from 1970-71 to 1989-90

(Figures in Rs. Crores)

Year	Direct Taxes				Indirect Taxes				Total Central Taxes (Gross Collection)	Corporation Tax as a Per Cent of Total Central Tax Revenue
	Corporation Tax	Taxes on Income other than Corporation Tax	Other Direct Taxes	Total Direct Taxes	Customs Duties	Union Excise Duties	Other Indirect Taxes	Total Indirect Taxes		
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
1970-71	371 (42.6)	473 (51.3)	26 (3.0)	870 (100.0)	524 (27.0)	1369 (70.0)	47 (2.4)	1940 (100.0)	2810	13.2
1971-72	472 (45.1)	537 (51.3)	38 (3.6)	1047 (100.0)	695 (29.6)	1586 (67.7)	61 (2.6)	2342 (100.0)	3389	13.9
1972-73	558 (45.1)	630 (50.9)	50 (4.0)	1238 (100.0)	857 (31.8)	1757 (65.3)	77 (2.9)	2691 (100.0)	3929	14.2
1973-74	583 (42.3)	745 (54.0)	51 (3.7)	1379 (100.0)	996 (32.6)	1971 (64.6)	85 (2.8)	3052 (100.0)	4431	13.1
1974-75	710 (43.0)	874 (53.0)	66 (4.0)	1650 (100.0)	1333 (33.7)	2528 (63.9)	95 (2.4)	3956 (100.0)	5606	12.7
1975-76	862 (39.1)	1214 (55.1)	129 (5.8)	2205 (100.0)	1420 (31.4)	2988 (65.9)	122 (2.7)	4530 (100.0)	6735	12.8
1976-77	984 (42.3)	1194 (51.3)	150 (6.4)	2328 (100.0)	1554 (31.7)	3194 (65.3)	147 (3.0)	4895 (100.0)	7223	13.6
1977-78	1221 (50.8)	1002 (41.6)	183 (7.6)	2406 (100.0)	1824 (34.3)	3335 (62.7)	160 (3.0)	5319 (100.0)	7725	15.8
1978-79	1252 (49.5)	1177 (46.6)	99 (3.9)	2528 (100.0)	2424 (36.0)	4102 (61.0)	200 (3.0)	6726 (100.0)	9254	13.5
1979-80	1392 (49.4)	1340 (47.6)	86 (3.0)	2818 (100.0)	2924 (44.1)	3481 (52.6)	213 (3.3)	6618 (100.0)	9436	14.7
1980-81	1311 (43.7)	1506 (50.2)	181 (6.1)	2998 (100.0)	3409 (46.0)	3723 (50.4)	264 (3.6)	7396 (100.0)	10394	12.6
1981-82	1970 (52.3)	1476 (39.2)	318 (8.5)	3764 (100.0)	4300 (48.8)	4181 (47.5)	329 (3.7)	8810 (100.0)	12574	15.7
1982-83	2185 (52.8)	1570 (37.9)	382 (9.3)	4137 (100.0)	5119 (51.0)	4567 (45.4)	366 (3.6)	10052 (100.0)	14189	15.4
1983-84	2493 (55.4)	1699 (37.8)	305 (6.8)	4497 (100.0)	5583 (45.9)	6164 (50.8)	404 (3.3)	12151 (100.0)	16648	15.0
1984-85	2556 (63.9)	1928 (28.3)	310 (7.8)	4704 (100.0)	7041 (49.8)	6626 (46.9)	464 (3.3)	14131 (100.0)	18925	13.5
1985-86	2865 (50.9)	2509 (44.6)	252 (4.5)	5626 (100.0)	9526 (56.5)	7330 (43.4)	12 (0.1)	16868 (100.0)	22494	12.74
1986-87	3160 (50.8)	2878 (41.4)	188 (3.0)	6226 (100.0)	11455 (58.1)	8164 (41.5)	70 (0.4)	19689 (100.0)	25915	12.19
1987-88	3433 (50.9)	3187 (47.2)	126 (1.9)	6746 (100.0)	13702 (59.1)	9423 (40.6)	68 (0.3)	23193 (100.0)	29939	11.45
1988-89	4407 (49.9)	4237 (48.0)	189 (2.1)	8833 (100.0)	15805 (58.9)	10922 (40.7)	121 (0.4)	26848 (100.0)	35681	12.35
1989-90 (R.E.)	4755 (47.5)	5000 (50.0)	249 (2.5)	10004 (100.0)	17877 (58.0)	12793 (41.5)	173 (0.5)	30843 (100.0)	40847	11.64

Note : Figures in brackets indicate percentages to horizontal totals of the respective category of taxes.

- Sources: 1) Eastern Economist, Budget No., Vol. 78, No. 11, March 19, 1982, pp. 269-270.
 2) R.B.I. Currency and Finance Report, Vol. II, 1984-85.
 3) R.B.I. Currency and Finance Report, Vol. II, 1986-87.
 4) R.B.I. Currency and Finance Report, Vol. II, 1989-90, pp. 122-123.

Table 2.3 : Share of Central Taxes in National Product, 1970-71 to 1989-90

Year	(Figures in Rs. Crores)								
	Direct Taxes (Gross Collection)		Total Indirect Taxes (Gross Collections)	Total Central Tax Revenue	NDP at Factor Cost at Current Prices	Per Cent Share of Central Taxes in NDP at Factor Cost at Current Prices			
	Corporation Tax	Total Direct Taxes including Corporation Tax				Corporation Tax	Direct Taxes including Corporation Tax	Indirect Taxes	Total Tax Revenue
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
1970-71	371	870	1940	2810	34519	1.07	2.52	5.62	8.14
1971-72	472	1047	2342	3389	36573	1.29	2.86	6.40	9.27
1972-73	558	1238	2691	3929	40270	1.39	3.07	6.68	9.76
1973-74	583	1379	3052	4431	50424	1.15	2.73	6.05	8.79
1974-75	710	1650	3956	5606	59737	1.19	2.76	6.62	9.38
1975-76	862	2205	4530	6735	62394	1.38	3.53	7.26	10.79
1976-77	984	2328	4895	7223	67597	1.46	3.44	7.24	10.68
1977-78	1221	2406	5319	7725	76330	1.60	3.15	6.97	10.12
1978-79	1252	2528	6726	9254	81429	1.54	3.10	8.26	11.36
1979-80	1392	2818	6618	9436	88563	1.57	3.18	7.47	10.65
1980-81	1311	1993	7395	9388	110139	1.19	1.81	6.71	8.52
1981-82	1970	2763	8810	11573	128417	1.53	2.15	6.86	9.01
1982-83	2185	3004	10052	13056	141965	1.54	2.72	7.08	9.20
1983-84	2493	3326	12151	15477	160586	1.80	1.2	7.30	9.30
1984-85	2556	3563	14131	17694	185697	1.38	1.96	7.69	9.53
1985-86	2865	4286	16894	21180	207848	1.38	2.06	8.13	10.19
1986-87	3160	4625	19689	24318	230865	1.37	1.76	8.53	10.54
1987-88	3433	4822	23193	28015	259618	1.32	1.86	8.93	10.79
1988-89	4407	6903	26848	33751	N.A.	-	-	-	-
1989-90 (R.E.)	4755	6955	30843	37798	N.A.	-	-	-	-

Note : Figures of NDP from the year 1983-84 are provisional.

Sources : 1) Eastern Economist, Budget Number, Vol. 78, No. 11, March 19, 1982, pp. 269-270.
 2) R.B.I. Currency and Finance Report, 1984-85, Vol. II.
 3) R.B.I. Currency and Finance Report, 1986-87, Vol. II, pp. 6, 106.
 4) R.B.I. Currency and Finance Report, 1989-90, Vol. II, pp. 122-123.

is more important than the rates of taxation themselves¹ because of the reasons given below.

(i) The base should remain stable for as long as possible while the rate, being applied to base, may have to be varied more frequently in response to the needs of the situation.

(ii) A vague tax base will create legal complications. Therefore, it is true that the principles and methods of determining the tax-base constitute the essence of the tax structure and should not be lightly or frequently changed. "In concrete terms the principles governing and the methods of determining the tax base should be built into the structure; the effective rates and policy oriented incentives and deterrents will be the levers."²

In the context of the Indian Income-Tax Act, 1961, the tax-base is known as 'total income'. Total income is arrived at not only after exclusion from total receipts of items which do not constitute income in ordinary or economic sense of the word but also excluding ingredients, which clearly are income, but which are sought to be exempt from taxation. For the sake of convenience and clarity, it would be explained as 'tax-base'. In relation to corporate income-tax, income means 'profit'. But the gross profit is not taxable. There are some exemptions for arriving at net taxable income. Computation of business income is a very complicated process. The concept of income is very broad.

Under Indian Income-Tax Act, tax is levied on the total income of the taxpayer i.e., 'all income from whatever source derived'.³ Therefore, "no item which is conceptually income would escape tax under one or another of the designated categories".⁴ Income includes salaries, interest on securities, profits and gains of business and professions, capital gains, profits and gains of any business of insurance carried on by a mutual insurance company the value of any benefit or perquisite, any winnings from lotteries, etc. The tax-base for corporation tax is the 'business income'. A company is liable to pay the corporation tax on its total earnings excluding income from agriculture. The taxable income of a company is determined in the same manner as that of an individual. Business income is computed as the difference between gross receipts and allowable expenses, depreciation and reductions. We shall discuss these items of deductions in detail in the next chapter.

According to the theory of the firm:

$$\begin{aligned} \text{i) Business income} &= \text{Revenue} - \text{Costs} \\ &= R - C \end{aligned}$$

$$\text{ii) Gross Revenue} - \text{exclusions} = \text{net taxable income.}^5$$

Exclusions means, the items of receipts not considered as 'income' for the purpose of levy of income-tax under the provisions of the Indian Income-Tax Act, 1961. For example, agricultural income of a person or a company is excluded from total income, while arriving at the taxable income. As such,

the items of receipt which are not subject to income-tax are excluded from gross revenue for arriving at net taxable income.

$$\text{iii) Net taxable income} - \text{Allowances and Relief} = \text{Net Taxed income}$$

Net taxable income is the base of corporate income-tax. "... the magnitude of the erosion of the tax-base depends on (a) size of exclusions and deductions from net profits or income, (b) certain administrative and technical reasons, (c) the reliefs which are given for promoting social and economical welfare, and (d) the size of slice of receipts initially admitted to the tax-base."⁶

Deductions are the amounts that law declares a taxpayer may subtract from his gross taxable income in arriving at his net taxable income. Deductions may include (i) business expenses such as wages, rent, cost of raw materials, etc., (ii) personal deductions like medical expenses, (iii) special deductions such as family allowance, development rebate, investment allowance, rural development allowance, etc. The nature of receipts subtracted and the method of subtraction have a logic and legitimacy because either it is a case of incentive to growth of corporation or of relief to taxpayer.

Generally, in almost all the countries the corporation income is the tax-base. The crucial difference lies in allowable expenses for achieving certain broader socio-economic objectives. Many of the tax-concessions are nearly

similar in many countries, e.g., investment allowances to promote corporate investment. These allowances are given in the United Kingdom, Belgium, Luxemburg, Netherlands, and many Swiss Cantons. Rhodesia and East Africa also grant investment allowances on investment in manufacturing machinery and equipment. "The rates of investment allowances vary between 10 per cent in Rhodesia and East Africa to 70 per cent and even 100 per cent in Argentina."⁷

In such cases the erosion of tax-base is inevitable but the basic objective here is broader, viz., promotion of social welfare, even with loss of governmental revenue. "To sum up the base for corporation tax in India is the commercial profits plus partially and completely disallowed expenses minus tax concessions or incentives."⁸ Therefore, it becomes very clumsy and leaves much to the discretion of tax administration and law courts to decide which receipts are inclusive and which are non-inclusive, as taxable income.

Tax-base according to Indian Tax law is different for different types of companies; for example, it differs according to (i) residential status of company, (ii) type of control and management of company, (iii) priority and non-priority industry in which the company is working. Tax-base is narrow in respect of widely-held companies, small domestic companies and newly set up Indian companies due to a variety of concessions and exemptions. On the other hand, due to less concessions, tax-base of non-resident companies,

closely-held companies and companies in non-priority industries is wider.

There are some scholars like I.S. Gulati and A. Bagchi, Ved. P. Gandhi, and V.D. Lall, who feel that business income is not a proper base for levying corporation income tax. The reasons put forward are as follows:

- (i) A tax on company profits puts a premium on debt financing as the interest on borrowed capital is an allowable deduction in computation of taxable income. Consequently, the mobilization of equity and risk capital is discouraged as against that of debt capital.
- (ii) Business income as a base of corporation tax presumably penalises efficiency of intramarginal firms.
- (iii) Another serious defect of income-base is that it reduces internal liquidity and at the same time reduces the attractiveness of equity capital for the corporation. "The ratio of retained profits to profits before taxes has declined over time for the sample companies of Reserve Bank of India. It was 25 per cent in 1955, 24 per cent in 1960 ... 20 per cent in 1966,"⁹ and declined further to 19.98 per cent in 1983-84. In 1987-88, retained earnings were almost -5.1 per cent.

(iv) Corporate profit base enables the companies to camouflage personal expenses of directors and officers on company accounts encouraging a cost-push effect on product pricing, it is a practice of shifting the tax on business expenditure."¹⁰

(v) V.D. Lall suggests that interest deduction provides an incentive for retention of profits and advancing capital-loans to subsidiary companies. It is more advantageous for the corporation than inviting additional subscriptions to paid-up capital to company. As a consequence, capital market for equity becomes sluggish.

I.S. Gulati and A. Bagchi, therefore, suggested two alternatives to profits as base for corporation tax, viz., (i) business expenditure of the company, and (ii) value-added tax (VAT).

Shifting the base from business-profits to business-expenditure will result in curbing even the essential business expenditure and shall raise the product price. Even the factor payments shall also be curtailed. In this case the corporation tax may show a tendency of backward shifting. If product price is increased due to inefficient use of resources, the tax shall be shifted forward to the consumers.

Introduction of value-added as a base for profit is highly complicated. It requires efficient administrative machinery to collect tax. The present state of administrative efficiency in India, it is feared, can hardly be relied upon to meet the requirements. Furthermore, value-added tax is also subject to forward and backward shifting possibilities. In such cases, the impact of tax on companies would be negligible.

V.D. Lall has criticized both the alternatives, business expenditure and value-added as bases for corporation tax for the reasons discussed above. Ved Gandhi, however, puts forward a strong case for value-added as a base rather than profits. "The value-added tax has the economic merits of efficiency, productivity, investment incentives, export promotion, which are very crucial for economic development."¹¹

2.3 Tax-Rates

Taxation of corporate income in India is as old as the tax on personal income. There have, however, been modifications as to the scope of its meaning from time to time depending upon the changes made in the Income-Tax Act as well as the changes that have taken place in the political set-up of India, particularly after Independence. "Changes in corporate tax structure since independence have largely been influenced by the Government's desire to control and regulate profits and to ensure a reasonable balance between their distribution and retention."¹²

Companies had to pay income tax only till 1917. Super tax on companies was imposed on a slab-system basis from April 1, 1917, on their undistributed profits. The distributed profits were taxed in the hands of the shareholders as part of their personal income. This simple procedure encouraged companies to set up and grow, to distribute more dividends and retain less profits for ploughing back into the business. Therefore, in 1920 super-tax was levied on companies at a flat rate of 1 anna in a rupee (6.25 per cent) on the entire profits exceeding Rs. 50,000. A provision was made under the Income Tax Act, 1922, under which income-tax paid by a company on its profits was deemed to have been paid by it on behalf of the shareholders and the shareholders got proportionate credit for this tax in their assessments. This principle was not accepted in the case of super tax on companies and therefore super tax was more or less like a corporation tax. This terminological confusion between income tax and super-tax on companies was finally removed by the Constitution which speaks of a 'corporation tax' to be levied and collected by the Union Government wholly for revenue purpose.

Company taxation was, however, simplified only in the Budget for 1959-60 when the system of grossing up of dividends was abolished and the entire tax paid by companies was treated as corporation tax. At the prescribed flat rates companies would deduct tax from dividends and deposit

it in the treasury. When the assessment of the shareholders is completed, the tax deducted at source from the dividend would be adjusted in their income-tax liability. The new scheme is very simple in operation "but it has created a problem of federal finance because under the Constitution the States cannot be given a share in the corporation tax."¹³

Between 1951-52 and 1956-57, the rate of income tax on companies was 5 annas in the rupee (31.25 per cent) and the rate of super tax was 4.5 annas in the rupee (28 per cent). From 1957-58, income tax began to be levied on percentage basis because of the country's switch over to metric system and decimal coinage.

From 1957-58 to 1959-60, the income tax rate was 30 per cent with a surcharge of 5 per cent. The super tax rate was 50 per cent on the whole of the total income but rebates were to be allowed depending upon (i) the nature of the company - there being a concession in favour of domestic companies and those which are not closely-held; (ii) the nature of income, a concession being shown in favour of dividend income derived from an Indian subsidiary,¹⁴ and (iii) the extent of income of the company, the distinction being between small company having an income of Rs.25,000 or less and others. In the case of all companies, where the assessee's income consisted of dividends from an Indian subsidiary, a rebate of 40 per cent thereof was given. In the case of any other income, the rebate was 35 per cent of

such income in the case of small domestic companies which were not closely-held, 30 per cent in the case of other domestic companies and 20 per cent in the case of non-domestic companies. This scheme was intended to encourage inter-corporate investment by Indian companies.

In these years also, the scheme of reduction in rebate based on the profits distributed as dividends and on issue of bonus and bonus shares continued. It was, however, made a little stringent. Dividends distributed in excess of 18 per cent of the paid-up capital were taxed to the extent of 30 per cent (as against 36 per cent earlier)¹⁵ and the rate on bonus-shares was increased to 30 per cent from 12.5 per cent.

During 1960-61, the system of company taxation was changed. Income tax on companies was charged at 20 per cent without any surcharge. The basic super tax rate was raised to 55 per cent from 50 per cent. Rebate was given to all companies at 45 per cent on all dividends from Indian subsidiaries.

A rebate of super tax in respect of dividends from Indian companies, which were formed on or after 1-4-1959, was provided for at 40 per cent to small domestic companies which were not closely-held, 35 per cent to large domestic companies, and 22 per cent to others. All other income was eligible for a rebate of 35 per cent in the case of small non-closely-held domestic companies, 30 per cent in the case

of large domestic companies and only 12 per cent in the case of other companies. Bonus amounts and bonus shares were taxed by reducing the rebate available to the extent of 30 per cent of such amounts or face value of shares. The rebate was minimum for foreign companies and maximum for small domestic companies, as an encouragement for investment in domestic companies. Hence a revenue loss was incurred by the government in respect of this rate differentiation. The position was same as in 1960-61 with two differences: (i) the tax on bonus shares was reduced to 12.5 per cent, and (ii) foreign companies were given a rebate at 25 per cent on the royalty income they received from Indian concerns.

The year 1962-63 was the first year of assessment under the Income-Tax Act, 1961. The income tax rate was stepped up to 25 per cent in that year. There was no change in the broad pattern of super tax levy and the tax on bonus shares at 12.5 per cent was continued on domestic companies. The scales of rebate from the basic rate of 55 per cent were as follows. (i) Small domestic companies not closely-held secured a rebate at a rate of 50 per cent on dividend income from Indian companies and 35 per cent on the other income. Therefore, such inter-corporate dividend was taxed at 5 per cent only and the effective rate otherwise was 20 per cent. (ii) Other domestic companies were having a higher rebate on the Indian dividend income - it was at 50 per cent, when received from an Indian subsidiary formed before

1961 and slightly lower, at 45 per cent in other cases. On the rest of the income, the rebate was 30 per cent resulting in an effective rate of 25 per cent. (iii) Foreign companies, also got the benefit of substantial rebates in respect of their dividend income from Indian companies but there was a three-fold classification: (a) Dividends from Indian subsidiary formed before 1st April 1961 - 50 per cent rebate. (b) Dividends from any other Indian Company formed on or after 1st April 1959 - 45 per cent rebate. (c) Dividends from Indian company not being a subsidiary formed before 1st April 1959 - 30 per cent rebate. The rebate on royalty income from Indian concerns was increased to 30 per cent from 25 per cent. The effective rate on other income was reduced to 38 per cent from 43 per cent. In 1964-65, the basic income tax rate continued to be 25 per cent with a rebate of 10 per cent to foreign companies on dividend income from a "non-section 108" company mainly engaged in certain priority industries. The basic rate of super tax was 55 per cent with different rebate rates, the details of which are given below. (i) Small-scale non-closely-held public companies got a rebate of 35.5 per cent. (ii) Large non-closely-held public companies got a rebate of 35 per cent in respect of their profits and gains from priority industries and of 30 per cent on their income from non-priority industries. (iii) Other domestic companies, engaged in specified priority industries and having a total income upto Rs.5 lakhs, got a rebate of 30 per cent on the first Rs. 2 lakhs and

25 per cent in respect of the balance of the total income. In addition, they got a rebate at 5 per cent in respect of income from specified industries upto Rs. 2 lakhs and 6 per cent of the balance of such income. (iv) Other domestic companies got a rebate of 26 per cent of their income from the priority industries and 20 per cent for the rest. The rebate available to domestic companies was liable to reduction to the extent of (a) 12.5 per cent of the bonus shares and (b) 7.5 per cent of the amount of dividend declared or distributed on its equity share capital by a widely-held company.

However, new companies were charged only on dividends declared in excess of 10 per cent of the paid-up equity capital during the period of five years from the first declaration of dividends. Here the tax and rebate structure were quite complicated and difficult to understand.

From 1965-66, the separate levy of super tax was abolished. Even though the combined rate of corporation tax was 80 per cent (basic tax plus super tax) on the total income, because of "the rebates and wide series of exemptions, the effective tax rate for companies in which public were substantially interested was 42.5 per cent".¹⁶ The scheme of rebates was also modified; for example, foreign companies were treated as before except that the higher rebate in respect of dividend income from companies engaged in specified industries was omitted.

Small-domestic companies, which are non-closely-held got rebate at 37.5 per cent and large companies of this type got rebate at 35 per cent on income from priority industries and 30 per cent on other income. In the case of other companies higher rebates were given, where they were engaged wholly or mainly in the specified or priority industries. The rebate was at 35 per cent on the first Rs. 10 lakhs and at 20 per cent on the balance. Where the companies were not wholly or mainly engaged in the specified industries, rebate was given at 26 per cent on such portion, if any, as could be attributed to the specified industries and at 20 per cent on the balance of total income. Also a reduction in rebate to the extent of 12.5 per cent on the amount of bonus and face value of bonus shares and 7.5 per cent on the dividends distributed was allowed as in the earlier year.

2.4 High Corporation Tax

In 1966-67 to 1969-70, the earlier complicated scheme of levy of tax, grant of rebate and reduction of rebate was given up and a simple rate structure of direct tax was introduced. A concession in respect of small companies and industrial companies was, however, retained. This pattern continued upto 1970. According to this structure, a foreign company had to pay a tax at a rate of 70 per cent except in respect of the income which they derived by way of royalties or technical fees from Indian concerns under agreements

entered into after the specified dates,¹⁷ which was liable to tax at 50 per cent; but, the defect of double taxation i.e. income tax and corporation tax on shareholders is still there. In relation to other countries the basic rates of corporation tax are very high. The highest rate acts as "a penalty on efficiency in all those cases where corporate profits are directly related to efficiency and not to monopoly".¹⁸ Therefore there is a recurrent suggestion for a reduction in the overall rates. It is now seriously affecting the incentives of the private investors as well as business corporations to save and invest. With confiscatory rates of taxes "the available international finance is becoming smaller and as a result the private sector is deprived of the finance necessary for its healthy growth and development".¹⁹

Indian corporations are said to be the highest taxed corporations in the world.

Our corporate tax system makes a difference between profits and interest in the computation of taxable income (profit). Interest paid is treated as cost and allowed for deduction before. This has tended to upset the balance between owned capital and borrowed capital of companies. They have gradually tended to increase the borrowed funds. In the RBI's sample companies the tendency of increasing share of borrowed funds was observed. Though a high corporation tax rate may be useful in checking the inflationary conditions

and monopoly tendencies, it may be harmful for attracting the supply of fresh share capital.

Table 2.4 : Rates of Corporation Income-Tax in the Selected Countries of the World, 1974-75

Country	Tax Rate	Country	Tax Rate
Austria	53.0	Luxemburg	40.0
Australia	42.5	Mexico	42.0
Belgium	30.0	Netherlands	46.0
Brazil	30.0	New Zealand	50.0
Canada	50.0	Norway	30.0
Ceylon	50.0	Italy	36.0
Denmark	44.0	Panama	45.0
Ethiopia	36.0	Philippines	30.0
France	50.0	Spain	34.0
West Germany	51.0	Switzerland	35.0
Ghana	50.0	Sweden	40.0
Greece	38.0	U.A.R.	28.0
<u>India</u>	<u>56.5</u>	U.K.	42.5
Japan	35.0	U.S.A.	48.0
Kenya	40.0	Venezuela	50.0

Source : Rao, V.G. The Corporation Income Tax in India.
Concept Publication, Delhi, 1980, p. 207.

The present tax system contains a variety of incentives including investment allowance, tax holiday, export concessions,

rural and agricultural development allowances, etc., which tend to reduce the effective rate of corporate taxation. Gandhi, Ved P. has suggested that the effective corporation tax rate in India "may be reduced from 55 per cent to 40 per cent or even 38 per cent, in the early years of operation of new widely-held priority enterprises".²⁰

Changes in the statutory tax rates and of surcharge on corporate income tax are shown in Table 2.5, covering a period from 1970-71 to 1986-87. For domestic companies, the rates were fixed according to type and size of the company. As such, (i) for non-closely-held small companies the tax rate was 45 per cent and for large companies the rate was 55 per cent; (ii) in the case of closely-held companies, the rate of tax was 65 per cent except where they were industrial companies; in the latter case, they had to pay tax at a rate of 55 per cent on the first Rs. 10 lakhs and at 60 per cent on the balance. The tax on bonus and bonus shares was discontinued with effect from 1-4-1966. The dividend tax continued for three years and discontinued from 1969-70.

Therefore, the tax structure became much simpler for all types of companies.²¹ Since then, there have been no major changes in the rate structure for companies, but there were various changes in deductions and incentives.

Between 1970-71 and 1980-81, the pattern of the earlier year was followed with some slight changes,²² e.g., foreign companies had to pay tax at 70 per cent and 50 per

Table 2.5 : Corporate Tax Rates on Companies in India, 1970-71 to 1986-87

Year	Statutory Tax Rate (Per Cent)			Surcharge on Corporation Tax	Average Tax Rate inclusive of Surcharge
	Widely-held Companies	Closely-held Companies	Average Rate		
(1)	(2)	(3)	(4)	(5)	(6)
1970-71	45 to 55	55 to 65	55	-	55.0
1971-72	"	"	55	2.5	56.37
1972-73	"	"	55	2.5	56.37
1973-74	"	"	55	5.0	57.75
1974-75	"	"	55	5.0	57.75
1975-76	"	"	55	5.0	57.75
1976-77	"	"	55	5.0	57.75
1977-78	"	"	55	5.0*	57.75
1978-79	"	"	55	5.0	57.75
1979-80	"	"	55	5.0	57.75
1980-81	"	"	55	7.5	59.12
1981-82	"	"	55	7.5	59.12
1982-83	"	"	55	2.5	56.37
1983-84	"	"	55	2.5	56.37
1984-85	"	"	55	5.0	57.75
1985-86	"	"	55	5.0	57.75
1986-87	"	"	55	-	55.00

* Corporations were given option to invest in IDBI deposits for five years an amount equivalent to 5 per cent surcharge on their income-tax.

Sources: 1) Inflation, Corporate Tax Provisions and Investment in India. Economic Research Division, Birla Institute of Scientific Research, Radiant Publishers, Delhi, 1985, p. 6.

2) Finance Bills 1971 to 1987.

cent in the earlier years. But the category of income by way of royalty and technical fees was divided into two categories, (i) in the case of agreements made after 31-3-1976 (i.e. for assessment year 1976-77 onwards), the rate of tax is reduced to 20 per cent on income by way of royalty but consists of a consideration for transfer or imparting of information outside India in respect of any data, etc., relating to any patent, etc., and (ii) 40 per cent on other income by way of royalty or technical fees. Here also inter-corporate dividends were charged at a concessional rate of 25 per cent.

For domestic companies, there was no major change in the tax rates for companies since 1970-71. In the case of domestic non-closely-held companies, the rates were 45 per cent and 55 per cent for small and large companies. However, the income criterion for determining a "small" company was raised to Rs. 1 lakh from assessment year 1974-75. In the case of closely-held domestic companies, the distinction between industrial companies and others was maintained. However, the limit upto which the concessional rate of 55 per cent was available in the case of said companies was reduced from the earlier Rs. 10 lakhs to Rs. 8 lakhs in 1970-71. All other closely-held domestic companies paid tax at 65 per cent as before.

The surcharge on income tax which had disappeared from the scene of corporate taxation from 1960-61, reappeared in 1972-73. It was levied at 2.5 per cent in 1972-73 and was

stepped up to 5 per cent in 1973-74 and in 1980-81 it was raised further to 7.5 per cent. For the assessment year 1977-78 alone, an option was given to a company to reduce the amount of surcharge to the extent a corresponding deposit was made with the Industrial Development Bank of India.²³

In 1981-82 and 1982-83, the Finance Acts have not changed the said pattern of the previous years. The Finance Act of 1982, however, reduced the rate of surcharge to 2.5 per cent.

The Finance Act 1983-84 proposed a change of non-differential rates of tax for domestic companies, such as the widely-held domestic companies should be charged at a uniform rate of 55 per cent and closely-held domestic companies should be charged at 60 per cent without any differential rate on the basis of total income. With this, the rate of surcharge was raised to 5 per cent from 2.5 per cent. The same scheme of a deposit with Industrial Development Bank of India was introduced for reducing the amount of surcharge to all domestic companies, which was inserted previously only in the year 1978.

In 1986-87, a minor change was incorporated in corporation tax rates, but a liberalised set of depreciation rules was introduced. "Depreciation will be allowed in respect of blocks of assets instead of the present system linked to individual assets."²⁴ There were only three rates of depreciation for plant and machinery, namely, 100 per cent,

50 per cent and 33.33 per cent. This was aimed at enabling companies write off more than 80 per cent of the cost of the plant and machinery in a period of four years and thus will be helpful for modernization and easier replacement of assets. Under inflationary conditions, this incentive will certainly provide a great relief to domestic companies.

Another welcome feature is that surcharge on companies, which was at the rate of 2.5 per cent was to be abolished from the assessment year 1987-88.

A Funding Scheme was introduced which replaced the scheme of Investment Allowance. Companies were allowed a deduction to the extent of 20 per cent of the profits, if these were deposited with the Industrial Development Bank of India (IDBI) or utilized for the purpose of purchasing plant and machinery. Both Investment Allowance and Funding Scheme would not be available at one and the same time. Apart from this, one more important provision was made by which every company was to pay a corporate tax rate of a minimum of 30 per cent on its book profits while a domestic widely-held company had to pay at least 15 per cent of book-profit. This was expected to yield a revenue of Rs. 75 crores to Government. There would be no zero-tax company henceforth.

The major relief in the 1981-82 Budget to the corporate sector came in the form of reduction in the rate of surcharge on corporate tax from 7.5 per cent to 2.5 per cent which would "in effect give a relief varying from 2.5 per cent to

3.5 per cent".²⁵ Formerly, companies in which the public are substantially interested were subjected to a tax of 55 per cent with 7.5 per cent surcharge, thus making the average tax rate of 59.125 per cent. The tax in respect of closely-held companies was 60 per cent with a surcharge of 7.5 per cent thus making the average tax rate of 64.5 per cent. The foreign companies were charged a tax of 70 per cent with a surcharge of 7.5 per cent, making the average tax rate 75.25 per cent. With the reduction in surcharge, the average tax rate was to be reduced to 56.375 per cent for widely-held domestic companies, 61.5 per cent for closely-held domestic companies and 71.5 per cent for foreign companies. Thus, we find that though the rates of corporation tax were not changed frequently there were frequent variations in the levy of surcharge and providing rebates and incentives.

Apart from this complicated structure of corporation tax, there were additional taxes attached to the said tax, e.g., Bonus-share Tax, Dividend Tax and Penal Tax. These were related to undistributed profits and restrictive in nature. These taxes are now abolished for the purpose of simplifying the tax structure.

Notes and References

1. Bhoothalingam, S., op.cit., p. 21.
2. Ibid., p. 24.
3. Section 5 of the Income Tax Act, 1961.
4. World Tax Series, Taxation in India. Harvard Law School International Program in Taxation, 1961, p. 157.
5. Borkar, V.V. Income-tax Reform in India. Popular Prakashan, Bombay, 1971, p. 13.
6. Ibid., p. 13.
7. Gandhi, Ved P., op.cit., p. 45.
8. Ibid., p. 43.
9. Ibid., p. 114.
10. Gulati, I.S. and Bagchi, A. "A Proposal for Reforming a Corporation Tax," Economic and Political Weekly, Annual Number, February 1975, p. 19.
11. Gandhi, Ved P., op.cit., p. 126.
12. Bishnoi, Usha. Union Taxes in India. Chugh Publication, Allahabad, 1980, p. 32.
13. Bhargava, R.N. "Union-State Relations in India," Commerce, May 15, 1965, pp. 886-887.
14. Subsidiary Companies are those Non-section 23-A Companies which had income not exceeding Rs. 25,000, in which the public were not substantially interested. Section 104 under the Income Tax Act, 1961.
15. This higher rate was restricted to widely-held companies; in the case of closely-held companies the rate was 20 per cent when dividends exceed 10 per cent of the paid-up capital.

16. Bishnoi, Usha, op.cit., p. 35.
17. Which were 31-3-1961 and 29-2-1964 respectively for royalties and technical fees.
18. Gandhi, Ved P., op.cit., p. 47.
19. Ghatalia, S.V. Recent Changes in Laws Affecting Business and Industry. Popular Prakashan, 1965, p. 143.
20. Gandhi, Ved P., op.cit., p. 110.
21. Cutt, James, op.cit., p. 278.
22. Bishnoi, Usha, op.cit., p. 35.
23. Companies Deposits (Surcharge on Income Tax) Scheme, 1976.
24. Reserve Bank of India Bulletin, Vol. I, 1985-86, p.279.
25. Bhoothalingam, S.; op.cit., p. 20.

CHAPTER 3

DEDUCTIONS AND ALLOWANCES

3.1 Introduction

Business corporations are allowed to enjoy certain deductions from taxable income under the provisions of Indian Income Tax Act, 1961. In addition, companies are also allowed to avail of certain allowances before arriving at the net taxable income.

Some of the important deductions and allowances which can be enjoyed by the companies in India are discussed. Such deductions include (1) expenses, depreciation, donations to charitable institutions and to scientific research, inter-corporate dividends, etc. (2) Allowances include development allowance, investment allowance, partial tax-holiday, priority industries' allowance, rural development allowance, agricultural development allowance, and export-market development allowance.

These deductions and allowances lead to reduction in the effective tax rate on companies providing incentives for investment and growth of business corporations. Changes in the deductions and allowances introduced by the Finance Acts from time to time have also been discussed in brief.

3.2 Depreciation

Depreciation is granted only on statutorily eligible capital assets, e.g., buildings, machinery, plant and furniture and that too on written down value of the asset at the statutory rate. The rates are fixed by the Central Board of Revenue and they are mandatory. The method of computation of income under the head 'profits and gains of business or profession' shall be computed in accordance with the provisions contained in sections 32, 34, 41, 43 and 43-A of the Income Tax Act, 1961.¹ The peculiarity of these provisions is that if there is not sufficient income in any year to absorb the depreciation charges, the deficiency can be carried forward indefinitely and set off against profits of subsequent years.

Depreciation can be classified into five categories:

- (a) ordinary depreciation,²
- (b) additional depreciation,³
- (c) initial depreciation,⁴
- (d) extra-shift allowance and extra depreciation,⁵
and
- (e) balancing charge and terminal allowance.⁶

The aggregate of depreciation allowance granted year after year (including initial depreciation, additional depreciation and extra-shift allowance) is in no case to exceed the actual cost of asset to the assessee. The asset should be owned by the assessee. Where, however, an assessee

corporation carries on business or profession in a building not owned by it but taken on lease, it is entitled to depreciation in respect of capital expenditure incurred by it after March 31, 1970, on construction of any structure or any work in relation to the building by way of improvement, renovation or extension.

(a) Normal Depreciation : Normal depreciation is allowed in respect of plant and machinery, building or furniture at the rates set out in Appendix I to the Income Tax Rules. For example, the rates mentioned in Appendix I are applied to actual cost in the case of ocean-going ships and the written down value in the case of other assets. Plant and machinery have been classified under five broad categories of useful lives, with rates of depreciation of 15, 20, 30, 40 and 100 per cent of the written down value of the assets irrespective of the period of user during the year. The general and residuary rates of depreciation in respect of machinery and plant is 15 per cent.⁷ Normal depreciation is not allowed in the year in which the assets are disposed off.

(b) Additional Depreciation⁸: Additional depreciation is allowed in respect of new machinery or plant installed after March 31, 1980, but before April 1, 1985. The additional depreciation is allowed in the year of installation of plant or machinery at the rate of 50 per cent of normal depreciation allowance (excluding extra shift allowance and

extra allowance in respect of plant or machinery installed in any premises used as hotel). No additional depreciation is, however, admissible in respect of ships, aircraft, road vehicles, office appliances or machinery or plant installed in any office premises or any residential accommodation.

(c) Extra Shift Allowance : This allowance is in addition to normal depreciation to plant and machinery. The rate of this allowance is 50 per cent of normal depreciation, and if the assessee claims allowance on account of triple shift, the rate of allowance is 100 per cent of normal depreciation. The extra-shift allowance for double and triple shift working is to be calculated separately in proportion in which the number of days for which the concern worked double or triple shift as the case may be, bears to the normal number of working days during the previous year. For this purpose, 'normal number' of working days will be: (a) in the case of seasonal factory, the number of days on which the factory actually worked, or 180 days, whichever is more, and (b) in the case of non-seasonal factory, the number of days on which the factory actually worked, or 240 days, whichever is more. Generally, the calculation of depreciation allowance in seasonal factory is as follows:

$$\text{Depreciation Allowance} = \frac{\text{Written down value on date}}{\text{Rate of depreciation}}$$

$$\text{Extra-shift allowance} = \frac{\text{Actual days of working of that machine}}{\text{Total days of working}} \times \frac{\text{Normal depreciation}}{2}$$

$$\text{Triple-shift allowance} = \frac{\text{Normal rate of depreciation} \times \text{Actual days of working}}{180 \text{ days}}$$

For a non-seasonal factory, the depreciation allowance is normally extra shift allowance, which is 50 per cent of normal depreciation.

Extra-shift allowance ceased to be available from the assessment year 1988-89.

(d) Initial Depreciation Allowance in respect of Building [Sec. 32(1)(iv)]: Initial depreciation is granted at the rate of 25 per cent on the actual cost of a new building, erection of which is completed after March 31, 1967 and is used by an Indian company as an approved hotel. From the assessment year 1984-85 this allowance is deductible for computing written down value for the next year.

Initial depreciation ceased to be available from the assessment year 1988-89 onwards.

(e) Terminal Allowance and Balancing Charge : This expression is used for the purpose of explaining section 41(2) of the Income Tax Act. If a depreciable asset is sold, discarded, destroyed or demolished, there may be a terminal allowance deductible, or a balancing charge inductible, in the computations of the assessee's total income. A question arises in this connection as to whether a transfer by way of an exchange or a compulsory acquisition of the asset in question is a transaction which may be treated as one giving rise to a terminal allowance or a balancing charge. Where

an asset owned by the assessee is sold and the moneys receivable in respect of such asset exceed the written down value thereof, the difference shall be chargeable to income tax as balancing charge. In case of an asset sold and the amount receivable falls short of the written down value thereof, the difference is allowed as terminal allowance.

(f) Concept of 'Block of Assets'⁹: With effect from Assessment Year 1988-89, depreciation shall be allowed on written down value of a 'block of assets' at prescribed rates. For this purpose, depreciable assets are classified under the broad categories of:

- i) Buildings - Residential and Non-Residential,
- ii) Furnitures and Fixtures,
- iii) Plant and Machinery - General, Indigenous, Technology based and Energy Saving and Pollution Control based
- iv) Ships.

Within each category, 'block of assets' consists of such assets for which the same rate of depreciation is prescribed under Rule 5 of the Income-tax Rules. Within each block, the individual asset is meant to lose its identity. There must exist at least one item of asset for the block to survive. The written down value of the 'block' for the assessment year 1988-89, shall mean the aggregate of the written down value of all the assets falling in that block

as on the beginning of 'previous year' as incremented by the cost of new assets forming part of the 'block' acquired during the year and as decreased by the amount realised or realisable on the sale, transfer, demolition, etc., of any asset of that 'block' during the year.

Further, the amended Income-tax Law allows only one method of depreciation, i.e. the written down value method. Therefore, even ships for which alone, the straight line method of depreciation was prescribed, shall now be depreciated using the written down value method of depreciation. All the other types of depreciation, viz. terminal allowance, balancing charge, initial depreciation allowance, extra shift allowance, etc., have been discontinued with effect from the Assessment Year 1988-89.

The General Rates of depreciation specified under the Income-tax Rules are:

For	i) Buildings (Non-Residential)	10%
	ii) Buildings (Residential)	5%
	iii) Furnitures and Fixtures	10%
	iv) Plant and Machinery (General)	33.1/3%
	a) Indigenous technology based	50%
	b) Energy Saving and Pollution Control based	100%

Depreciation would be allowed at the above rates for the entire year irrespective of the period of use during the year.

With effect from Assessment Year 1988-89, if any asset on which depreciation has been allowed is sold, discarded, demolished, etc., the net sale proceeds realised/realisable shall be deducted from the written down value of the respective 'block of assets'. The balance, if negative, (i.e. the sale proceeds higher than the written down value of the entire block) such excess balance shall be taxed as 'Deemed Short Term Capital Gain' in the year of sale, transfer, demolition, etc. Thus, with effect from the Assessment Year 1988-89, even if an asset has been held for more than 36 months, if depreciation has been claimed on it in respect of any Assessment year, the gain arising on sale of such asset/s shall be taxable as short term capital gain irrespective of the period of holding.

3.3 Amortization of Certain Preliminary Expenses¹⁰

With effect from 1st April, 1971, if an Indian company incurs any expenditure before or after commencement of business, on preparation of feasibility report, project report, conducting market survey, engineering services relating to the business of the company, it shall be allowed a deduction of an amount equal to 1/10th of such expenditure for each of the ten successive previous years. Similarly, legal charges for drafting any agreement or of a contract is also an allowance deduction under this clause. In case of companies, legal charges for drafting the Memorandum and Articles of Association, printing thereof, fees for registering

the company and expenses in connection with issue of shares and debentures, e.g. underwriters' commission, brokerage, etc., are allowable deductions under the same section.¹¹

The total expenditure allowable is limited to 2.5 per cent of the cost of the project or actual expenditure whichever is lower.¹²

3.4 Deductions in respect of Inter-Corporate Dividends¹³

To encourage corporate savings, inter-corporate dividends are taxed on a concessional basis. Prior to 1972-73, deduction on account of this provision was 60 per cent for dividends received by a domestic company from any other domestic company; 80 per cent for dividends received by a foreign company from a domestic company mainly engaged in a priority industry and 65 per cent in other cases. Hence the effective rate of tax worked out to 22 per cent in the case of a widely-held domestic company and 26 per cent in the case of a closely-held non-industrial domestic company. For a foreign company the effective rate on dividends received from a closely-held Indian company mainly engaged in a priority industry worked out to 14 per cent. However, the special concessional treatment to foreign companies has been withdrawn by the Finance Act, 1971. From the assessment year 1976-77 onwards, income from inter-corporate dividends received by domestic companies from new companies engaged in priority industries has been exempted from tax. This concession is, of course, aimed at encouraging more

investment in new and risky ventures.

3.5 Deduction in respect of Donation to Certain Funds: Charitable Institutions, etc.¹⁴

All types of assesseees are entitled to a deduction in respect of donations paid in the previous year to approved funds or institutions in the computation of their total income. The donations should be paid to the following funds or institutions:

- i) The National Defence Fund, set-up by the Union Government; or
- ii) Jawaharlal Nehru Memorial Fund; or
- iii) Prime Minister's National Relief Fund; or
- iv) Any other funds or institutions, which are established in India for a charitable purpose and which fulfil certain conditions.¹⁵

No deduction is allowed if the aggregate of donations made in a previous year is less than Rs. 250. The deduction is to be allowed at the following rates:

- a) in a case, where the aggregate sum of donations under section 80-G(2) includes any sum paid to the government, local authority, institution or association to be utilized for the purpose of promoting Family Planning Programme, hundred per cent of the qualifying amount plus fifty per cent of the balance of such aggregate, and
- b) in any other case, an amount equal to fifty per cent of the aggregate of the sums.¹⁶

Conditions for such a deduction include that the receiving institution or fund must be fully exempted from tax; income or assets of the institution or fund must be applied for charitable purpose, etc. The qualifying amount of deduction under donations is subject to a maximum limit of aggregate donations or ten per cent of the net taxable income before allowable deduction for donation or Rs.5 lakhs, whichever is less.

3.6 Development Allowance¹⁷

The budget of 1965-66 introduced an additional Development Allowance. It is given to Tea Industry for new plantings and replanting of tea bushes, to the extent of 30 per cent to 50 per cent. The conditions are similar to those for development rebate. Unabsorbed development allowance can be carried forward for eight years.

Income derived from the sale of tea grown or manufactured by the seller is computed as income from business and only 40 per cent of such income is taxed. A recent addition to this provision is that 'an amount equal to 75 per cent of the development allowance to be actually allowed must be debited to the Profit and Loss Account of the previous year the assessment in respect whereof such actual allowance is to be made'. But it is not necessary to create a reserve equal of the actual allowance. This has been approved by Central Board of Direct Taxes,¹⁸ vide its Circular No. 325 of February 3, 1982. In 1982-83 budget, the condition of

maintaining reserves equal to development allowance was withdrawn.

3.7 Export Market Development Allowance¹⁹

The Finance Act, 1968, introduced the Export Market Development Allowance under which domestic companies and resident non-corporate taxpayers, incurring expenditure for development of export markets for Indian goods on a long-term basis, are entitled to a deduction from total income of 1.5 times the amount of qualifying expenditure incurred on (i) advertisement and publicity outside India, (ii) obtaining information regarding markets outside India, (iii) distribution, supply or provisions of goods, services or facilities outside India, (iv) maintenance of branches of sales outside India, and (v) travelling outside India for promotion of sales, etc.

Under this provision some special benefits in taxation were made available to domestic companies, and to resident assesses other than companies if they fulfilled the requirements prescribed by the said provisions. These provisions are contained in section 35-B. The benefit was substantially curtailed with effect from assessment year 1979-80. Thereafter, amendments were again made by the Finance (No.2) Act, 1980. From August 1, 1981, certain items were brought under the purview of section 35-B by a Notification. By the Finance Act, 1983, however, the operation of section 35-B in respect of any expenditure incurred after February 28,

1983 was made inoperative. There are many associations which are engaged in intensive research and development activities mainly with the idea of satisfying the needs of the foreign markets. It is argued that such expenditure should also qualify for the said benefit. For that purpose, a suitable amendment should be made to the said section.

It is also not clear as to why a non-Indian company or a non-resident assessee has been excluded from the said benefit. The object of the export market development allowance may be the earning of more foreign exchange by Indian companies and individuals. But now it is very clear that, section 35-B is inoperative for any expenditure on export market development incurred after February 28, 1983. "If, however, the expenditure on export promotion is incurred through a representative association, like Chamber of Commerce, the benefit under section 35-B will still be available."²⁰

3.8 Priority Industries' Allowance²¹

Domestic companies in priority industries are allowed a deduction equivalent to 25 per cent of their 'total income' in computing their taxable income. This benefit is also made available to the business of repairs to ocean-going vessels or other powered craft carried on by a company.²² If in a particular year the whole amount of eligible deduction allowed under section 80-J²³ could not be absorbed by a company due to paucity of profits in that year, the shortfall

(termed deficiency) could be carried forward to a later year, not beyond the eighth year from the year of commencement and adjusted against the profits of the undertaking.

3.9 Minor Items of Machinery and Plant²⁴

In respect of plant and machinery, whose cost does not exceed a certain prescribed limit (Rs. 750 for and upto the assessment year 1983-84 and Rs. 50,000 with effect from the assessment year 1984-85), the entire cost is to be allowed as a deduction in the assessment for the very first year in which the said item of plant and machinery is brought into use in the assessee's business. It may be appreciated that in such a case where a deduction for minor items of plant and machinery is availed of, there cannot be any further allowance for the same asset by way of depreciation or otherwise.

3.10 Rural Development Allowance²⁵ and Agricultural Development Allowance²⁶

Where an assessee incurs expenditure by way of payment of any sum to an association or institution to which this section applies, to be used for carrying out any programme of rural development approved by the prescribed authority, the assessee shall be allowed a deduction of the amount of such expenditure incurred during the previous year. But the programme should be approved by the prescribed authority or it is in the form of the training of persons for implementing programmes of rural development, programme of conservation of natural resources, etc.²⁷

The overall limit of deduction as prescribed under section 80-VVA applies here (deduction should not be more than 70 per cent of profits). Such expenditure is to be allowed for deduction for not more than three years at a time.²⁸

3.11 Investment Allowance²⁹

In 1954 the scheme of development rebate was introduced and it continued to be operative for 20 years. It helped substantially in the industrial development of India. For some time past, capital costs had sharply increased. Hence the Finance Minister rightly felt that "unless the corporate sector is enabled to provide adequately for renewals and renovation, employment and industrial growth will be jeopardized".³⁰ Fiscal policy should, therefore, be oriented to provide necessary stimulus for the growth and modernization of the corporate sector. The Budget for 1976-77 extended the investment allowance scheme to all except 29 low priority large scale industries. It is an allowance over and above the depreciation at the rate of 35 per cent on machinery and plant installed for the manufacture of any article in accordance with the "know-how developed in Governmental laboratories, public sector companies, universities and recognized institutions".³¹ The list of industries qualifying for investment allowance has been extended by including eight other priority or export-oriented industries viz., carbon and graphite products, inorganic

heavy chemicals, synthetic rubber and rubber chemicals, basic drugs, finished leather, etc." Hence the provision of development rebate or investment allowance is in existence for promoting the growth of industries and encouraging reinvestment of surplus funds. "The effect of the development rebate together with the depreciation allowance is to permit accelerated amortization of the cost of many new assets."³²

It may be mentioned here, that although the investment allowance is very useful and good substitute to development rebate, it is not available now for all industrial undertakings. The Finance Act (No.2), 1977, inserted the limitation, that it is not available, except in the case of small-scale industrial undertakings, on plant and machinery used for the purposes of manufacturing or producing any article or thing specified in the list in the Eleventh Schedule or non-priority undertakings.

A major change of law in regard to the availability of investment allowance has been effected by the Finance Act, 1983, which became effective from the assessment year 1984-85 whereby it has been provided that along with certain other deductions referred to in section 80-VVA, the maximum deduction for the aggregate of such items inclusive of this allowance is limited to 70 per cent of profits before granting any of these deductions.

For creation of reserves, an amount equal to 75 per cent (50 per cent in the case of ships) of the investment

allowance to be actually allowed, should be debited to the profit and loss account of the previous year in respect of which deduction is claimed and should be credited to the "Investment Allowance Reserve Account".³³

3.12 Partial Tax Holiday³⁴

It is an incentive to new industrial undertakings, including ship-manufacturing and hotels. New industrial undertakings manufacturing or producing articles and established after March 31, 1948 were exempted from tax on their profits for five years to the extent of 6 per cent of capital employed. This concession was also available to cold storage plants and plying of ships. Cooperative societies can also avail similar partial tax holiday, but the period of tax exemption for cooperative societies was 7 years as against 5 years for other undertakings. Under section 80-J of the Income Tax Act, 1961, for new business units the quantum of benefits is $7\frac{1}{2}$ per cent of the "relevant amount of capital employed as on the first day of the computation period".³⁵

The unabsorbed amount, if any, can be carried forward for eight years - the dividends paid out of such tax-exempt profits of the new industrial undertakings are tax-exempt in the hands of the shareholders also. The aim of such facility is to encourage new investment in priority sector and in those enterprises which are generally not in a position to have adequate profits in the initial years. "As the interest

payable on all borrowings is already allowed as a deduction in arriving at taxable profits, the inclusion of such debentures and borrowings again in the capital base for calculating capital for tax-holiday purposes, created a bias in favour of borrowed capital as against equity capital." Therefore, the Finance Act, 1971, changed the definition of the term 'capital employed' to exclude all borrowed money. Another change took place in 1974-75 Budget; that is, the tax exemption in relation to dividends received by shareholders out of this provision relating to new industrial undertakings, hotels and ships was withdrawn. Instead, the quantum of tax-exempt profits in the case of companies was increased from 6 per cent to 7.5 per cent of the capital employed, to encourage investment of corporate savings in high priority industries.

In 1978-79 Budget, the tax-holiday scheme was withdrawn for low priority industries, e.g., alcoholic beverages, tobacco and tobacco preparations and cosmetics, etc.

The 'Tax Holiday Scheme' was modified materially in 1980-81 Budget. The basis of computing tax-holiday was changed from capital employed to a percentage of taxable income derived from new industrial units, ships or approved hotels. In the case of companies, 25 per cent of profits derived from the new industrial undertakings, etc., was exempted from tax for a period of seven years and in the case of non-corporate entities 20 per cent of such profits

was exempted for a like period. Cooperative societies, however, would enjoy this exemption for a period of 10 years instead of seven years. It is also admissible to all small-scale industrial undertakings except the undertakings which are engaged in the production of articles other than those listed in the Eleventh Schedule of Income Tax Act, e.g., undertaking producing alcoholic beverages, tobacco, etc.

It seems that the tax-holiday incentive is occupying an important place in industrial world and in government policies, because it promotes the social and economic objectives while giving differential treatment to large-scale and small-scale industries. This is considered desirable and necessary for the promotion of priority industries especially in their initial period.

This incentive is very popular in other countries also such as Ceylon, Ethiopia, Nigeria, U.A.R., Ghana and Switzerland.

Though the 'tax-holiday' approach is neutral between capital-intensive and labour-intensive business, it is more useful for developing the densely populated countries, like India as the growth of industry is mainly guided by the cheap supply of labour force.

3.13 Tax-Credit-Certificates³⁶

Since 1965, Tax-Credit-certificates of varying amounts

have been allowed towards the cost of shifting of industrial undertakings by a public limited company from urban areas to rural areas, on the sale-proceeds of exports, and on the excess of production over a "base year" production. The latter two items of credit are available only for certain goods specified by the Government. Tax-credit-certificates are also available to industrial companies liable to income-tax and sur-tax in excess of such taxes payable in the "base year". The amount adjusted or paid to the assessee in respect of the tax-credit-certificate granted to him, is exempt from inclusion in his total income.

Notes and References

1. i) Section 32, The Income Tax Act, 1961.
 ii) Section 34, Conditions for depreciation allowance and development rebate: inserted by the Taxation Laws (Amendment) Act, 1970, w.e.f. 1-4-1971.
 iii) Inserted by the Finance Act, 1975
 iv) Inserted by the Finance (No. 2) Act, 1980, w.e.f. 1-4-1981.
 v) Finance Act, 1973-74, discontinued/stopped the development rebate from 1975-76.
2. Inserted by Finance Act, 1964-65: Rule 5 of the Income Tax Act, 1962.
3. Finance (No. 2) Act, 1980, clause (iia) was inserted in sub-section (1) of section 32.
4. Income-Tax Act Rules, 1962, Depreciation Table Appendix I.
5. Ibid.
6. Described in section 41(2) of the Income Tax Act, 1961.
7. From the assessment year 1988-89, the general and residuary rate of depreciation in respect of plant and machinery is increased to 33.1/3 per cent.
8. By the Finance (No. 2) Act, 1980, clause (iia), sub-section (1) of section 32.
9. Haribhakti, Shailesh and Ruparelia, Atul. Depreciation: Key Policy Choice. A paper presented at the Seminar on Taxation organized by the Institute of Chartered Accountants, Western India Regional Council, Nasik on 10th October 1987.
10. Section 35-D, Income Tax Act, 1961, inserted by Taxation Laws (Amendment) Act, 1970, section 7.

11. Section 35-D(2)(b), Income Tax Act, 1961.
12. Jain, Anilkumar, op.cit., p. 129.
13. Income Tax Act, 1961, Section 80-M.
14. Section 80-G of Income Tax Act, 1961.
15. Section 80-G(2), as explained by B.B. Lal. Elements of Income Tax. Vikas Publishing House Private Ltd., New Delhi, 1978, pp. 399-400.
16. Section 80-G(1) substituted by Finance Act, 1976 (66 of 1976), section 17.
17. Section 33(A) inserted by Finance Act, 1965 and Finance Act, 1975.
Tax Rules, 1962, Rule 8-A.
18. Central Board of Direct Taxes, Circular No. 325, dated February 3, 1982, from Bhattacharya, Sukumar. Indian Income Tax - Law and Practice (16th edition). Eastern Law House Private Ltd., Calcutta, p. 301.
19. Income Tax Act, 1961, section 35-B.
20. Bhattacharya, Sukumar, op.cit., p. 310.
21. Income Tax Act, 1961, section 80-I.
22. By an amendment made by the Finance Act, 1983, and effective from the assessment year 1984-85.
23. Section 80-J, Income Tax Act, 1961, provision for new business undertakings.
24. Income Tax Act, 1961, section 32(1)(ii).
25. 35-CCA to be deducted under section 80-GGA was inserted in Chapter VI-A by the Finance Act, 1979.
26. 35-C inserted in 1968.
27. 35-CCB(2).

28. Amendment introduced under section 5 of the Finance Act, 1979.
29. By the Finance Act, 1976, section 32-A was inserted in the Income Tax Act, 1961, w.e.f. April 1, 1976.
Some changes made by Finance Act, 1977 and Finance Act, 1987.
30. Finance Minister's Budget Speech (1976-77).
31. Report on Currency and Finance, 1976-77, Reserve Bank of India, p.
32. Cutt, James, op.cit., p. 277.
33. Singhanian, Vinod. Students' Guide to Income Tax. Taxman Publications (P) Ltd., Delhi, 1987, p. 191.
34. Income Tax Act, 1961, section 80-J.
Finance (No. 2) Act, 1967, Government of India.
35. Finance (No. 2) Act, 1967, Government of India.
36. Income Tax Act, 1961, section 280-ZA to 280-ZD.
Income Tax Act, 1961, section 33-A.
By the Finance Act of 1965 by clause (28) of section 10.

CHAPTER 4

IMPACT OF CORPORATE INCOME TAX

4.1 Introduction

After discussing the rate structure and various deductions and allowances at some length in earlier chapters, we may now turn our attention to a discussion of 'effective rate' of corporation tax in India and its impact on saving, investment, capital structure and profitability trends in the business corporations during the period under review, i.e. from 1970-71 to 1989-90.

4.2 Effective Tax Rate

Dictionary meaning of effective tax rate is 'the average rate of tax on the gross income', after making allowances for various admissible deductions from the gross income. Effective tax rate differs from statutory tax rate due to various tax deductions exemptions and concessions available to the corporate sector. For assessing the impact of corporation tax on various aspects of corporate sector, effective tax rate, rather than statutory rate is relevant. Ved P. Gandhi has defined effective tax rate as "the ratio of tax provision by the companies to their profits before tax".¹ (PBT).

Effective tax rate for small and medium and large

sample companies of the Reserve Bank of India during the period from 1975-76 to 1988-89 has been worked out as defined above and shown in Table 4.1.

$$\text{Effective Tax Rate} = \frac{T}{\text{PBT}} \times 100$$

where T = Total Tax paid by the companies, and
PBT = Profits before Tax of the companies.

By making use of RBI data about working of sample companies in the private corporate sector, we can work out corporation tax paid by the companies by subtracting dividends paid and retained earnings from PBT, and find out the effective tax rate through the equation.

$$\text{Effective Tax Rate} = \frac{\text{PBT} - \text{PAT}}{\text{PBT}} \times 100$$

where PBT = Profits before tax,

PAT = Profits after tax, which includes dividends and retained earnings.

Thus, PBT - PAT is the amount of corporation tax paid by the companies.

Year to year information about profits before tax and profits after tax has been obtained in respect of the Reserve Bank's sample companies from its 'Reports on Currency and Finance'. For instance, in the year 1987-88, profit before tax of 1953 small and medium sample companies was Rs. 1437 crores when the profits after tax was Rs. 650 crores only, thus,

Table 4.1 : Computation of Effective Corporation Tax Rate for Small and Medium and Large Companies (R.B.I's Sample) for the Period 1970-71 to 1987-88 (Gandhi, V.P. Formula)

(Rs. Crores)

Year	Small and Medium Companies					Large Companies				
	No. of Companies	PBT	PAT	Tax Actually Paid	Effective Tax Rate (5/3)	No. of Companies	PBT	PAT	Tax Actually Paid	Effective Tax Rate (10/8)
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
1970-71	1650	535	312	223	41.70	Data not available				
1971-72	1650	565	309	256	45.31	---	"	---		
1972-73	1650	598	318	280	46.82	---	"	---		
1973-74	1650	740	386	354	47.83	---	"	---		
1974-75	1650	1021	522	499	48.90	---	"	---		
1975-76	1650	800	328	472	59.0	404	669	307	362	54.11
1976-77	1720	823	336	487	59.17	404	716	334	382	53.35
1977-78	1720	893	383	510	57.11	426	744	342	402	54.03
1978-79	1720	1102	538	564	51.18	426	894	453	441	50.70
1979-80	1720	1424	759	665	46.70	426	1121	600	521	46.50
1980-81	1800	1622	916	706	43.53	486	1222	704	518	42.40
1981-82	1800	1665	925	730	43.84	486	1374	816	558	40.06
1982-83	1838	1599	1010	589	36.84	500	1204	777	427	35.50
1983-84	1838	1296	657	639	49.31	500	1086	618	468	43.09
1984-85	1942	1735	948	787	45.40	581	1504	919	585	38.90
1985-86	1953	2137	1281	856	40.06	621	1714	1051	663	38.70
1986-87	1953	1696	965	731	43.10	622	1465	955	510	34.80
1987-88	1953	1437	650	787	54.77	622	1399	833	566	40.50
1988-89	N.A.	N.A.	N.A.	N.A.	-	622	2180	1454	726	33.30

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Note : PBT = Profits before tax. PAT = Profits after tax.

- Sources:**
- 1) R.B.I. Report on Currency and Finance, Vol. II, 1977-78, p. 67.
 - 2) R.B.I. Report on Currency and Finance, Vol. II, 1983-84, p. 75.
 - 3) R.B.I. Report on Currency and Finance, Vol. II, 1984-85, p. 76.
 - 4) R.B.I. Report on Currency and Finance, Vol. II, 1986-87, p. 74.
 - 5) R.B.I. Report on Currency and Finance, Vol. II, 1987-88, p. 74.
 - 6) R.B.I. Report on Currency and Finance, Vol. II, 1989-90, p. 122.

$$\begin{aligned}
 \text{Effective Tax Rate} &= \frac{\text{PBT} - \text{PAT}}{\text{PBT}} \times 100 \\
 &= \frac{1437 - 650}{1437} \times 100 \\
 &= \frac{787}{1437} \times 100 \\
 &= 54.77 \text{ per cent.}
 \end{aligned}$$

Effective tax rate thus worked out from year to year 1970-71 to 1988-89 for small and medium as well as for large public limited companies (with a paid-up capital of Rs. 1 crore and above) is shown in columns 6 and 11 respectively in Table 4.1. The higher the effective tax rate, lower will be the dividend distribution and/or retained earnings of the companies, ceteris paribus. The average effective tax rate was lowest at 41.7 per cent in 1970-71 mainly because of absence of surcharge on corporation tax. The rate started rising from 1971-72 and thereafter continued to rise further to around 49 per cent by 1974-75, when a surcharge of 2.5 per cent was levied on corporation income tax. In 1974-75, the rate of surcharge on corporation Income Tax was raised from 2.5 per cent to 5 per cent. In addition, some tax concessions were withdrawn. For instance, special deductions for concessional rate of statutory rate at 55 per cent on first Rs. 10 lakhs income formerly available to closely-held companies was then made available to first Rs. 2 lakhs only with effect from 1972-73. This has enhanced the tax liability of the companies.

Effective tax rate was at its peak for both types of companies small and medium, and large, during the period 1975-76 to 1977-78. This was mainly because of the fact that only 85 per cent of the interest paid by the companies on public deposits was allowed as deductible expenditure for computing their taxable income. This provision was expected to have yielded additional revenue of Rs.10 crores in 1974-75 and Rs. 7.5 crores in 1975-76.² In addition, tax exemption on dividends received by the shareholders out of tax holiday profits of new industrial undertakings, hotels and ships was withdrawn from the budget, 1974-75.

In the budget of 1975-76, the scheme of development rebate was withdrawn and replaced by the new scheme of investment allowance. Under this scheme, investment allowance was allowed at a rate of 25 per cent of the cost of new machinery and plant installed after March 31, 1976. This allowance would be liable to tax if the reserves created out of it were not utilized for acquiring new machinery within a period of ten years. As such, withdrawal of development rebate has pushed up the effective rate for a short period of three years ending March 1978.

In 1977-78 a provision was made disallowing a part of the expenditure on advertisement, publicity and sales promotion in computation of taxable profits of business in excess of Rs. 40,000. The rates of disallowance were determined with reference to percentage of such expenditure to the

total turnover of the business. This must have resulted in keeping the effective tax-rate high at 57.11 per cent for small and medium companies and at 54.03 per cent for large companies.

After 1979-80, the average effective tax rate was fairly stable upto 1984-85, ranging between 44 per cent and 49 per cent for small and medium companies and between 40 and 50 per cent for large companies. The effective tax rate was lowest in 1982-83, when the provision of maintaining reserves equal to actual development allowance was relaxed. Effective tax rate finally shot upto 55 per cent for small and medium companies and upto 40.5 per cent for large companies in 1987-88, when V.P. Singh's budget for 1986-87 replaced the scheme for investment allowance by a new funding scheme. The budget also brought in a system of allowing depreciation in respect of block of assets in place of depreciation on individual assets. These two major changes were, perhaps, responsible for 6 to 7 percentage point rise in effective tax rate over immediately preceding year, 1986-87.

Though we may be able to calculate effective tax rate on corporate income, we can at the most work it out as an average rate, taking together all types of companies. The RBI data are not available for widely-held and closely-held domestic companies and foreign companies separately. In fact, the statutory rates for different types of companies are different. If we could find out effective tax rates for

different types of companies it would have been better to comment on the varied impact of the tax on each type of companies viz., widely-held domestic companies, closely-held domestic companies, and foreign companies.

We can, however, note that large companies enjoy more benefits of deductions and allowances as compared to small and medium companies. Throughout the period 1975-76 to 1987-88 for which comparative data are available, effective tax rate for large companies is lower than that for small and medium companies. This seems to be at variance with the state policy of protecting small sector.

Another method for calculation of effective tax rate is to find out the ratio of net tax collection to the total corporate income assessed for the purpose. Statistical information about number of assessee companies in each category, their assessed income and tax demand is available in the Annual Income Tax Statistics, Annual reports published by the Directorate of Inspection (Research Statistics and Publicity), New Delhi. However, the information available is discontinuous. The Directorate of Inspection did not publish Annual Reports for the years 1970-71 and 1972-73 and data from the year 1984-85 are not available. We may therefore calculate effective tax rate for each type of companies as well as the average tax rate for all companies for the purpose of comparison with other methods of calculating effective tax rate. The period chosen

Table 4.1(a) : Corporation Income Tax Demand and Effective Tax Rate, by Categories of Companies, 1974-75 to 1981-82

Year	(Rs. Crores)															
	Widely-held Domestic Companies				Closely-held Domestic Companies				Foreign Companies				All Companies			
	Number of Assessments	Income Assessed	Tax Demand	Effective Tax Rate %	Number of Assessments	Income Assessed	Tax Demand	Effective Tax Rate %	Number of Assessments	Income Assessed	Tax Demand	Effective Tax Rate %	Number of Assessments	Income Assessed	Tax Demand	Effective Tax Rate %
1974-75	2217	459.3	262.3	57.1	8020	197.8	119.2	60.26	689	40.7	27.7	68.06	10926	697.8	409.2	58.6
1975-76	3483	608.5	346.4	56.9	8855	182.0	110.2	60.55	966	56.9	39.4	69.2	13304	847.4	496.0	58.5
1976-77	3548	625.2	362.0	57.9	8617	168.8	104.1	61.67	1454	92.4	64.6	69.9	13619	886.4	531.5	59.9
1977-78	3442	774.0	444.7	57.5	9679	177.3	109.9	62.0	1464	86.7	57.5	66.3	14585	1038.0	612.1	59.8
1978-79	2863	1056.0	590.9	55.9	7405	193.4	119.5	61.8	1189	96.7	64.2	66.4	11457	1346.1	774.6	57.5
1979-80	3001	1585.0	801.4	50.6	7434	293.4	188.2	64.1	1201	142.0	85.5	60.2	11636	2020.4	1075.1	53.2
1980-81	2860	1151.6	660.8	57.4	7004	183.3	114.5	62.5	1241	129.3	74.3	57.5	11105	1464.2	849.6	61.2
1981-82	2736	1153.6	580.0	50.3	7062	286.9	175.4	61.1	1130	82.9	47.0	56.7	10928	1523.4	802.4	52.7

N. B. : Effective Tax Rate is the ratio of tax demand to income assessed.

Source: Director of Inspection (Research, Statistics and Publications), New Delhi. All India Income Tax Statistics, 1974-75 to 1981-82.

and 58 per cent next to widely-held domestic companies which paid an ETR ranging between 60 and 64 per cent, during the period under review. ETR for foreign companies is expected to be highest as compared to domestic companies but to our surprise it is not so. Table 4.1(a) shows that during three out of eight years i.e. from 1979-80 to 1981-82, effective tax rate for closely-held domestic companies is higher than the rate for foreign companies. It can be easily grasped from the Table that effective tax rate for foreign companies had been less than the statutory rate whereas domestic widely-held and closely-held companies pay a slightly higher rate of effective tax than the statutory rate.

Though the discussion of Effective Tax Rate by categories of companies may be very useful for examining its impact on various aspects like saving, investment, allocation of profits, etc., systematic and continuous data about tax collection and income of the domestic and foreign companies is not available.

A third method by which we can work out effective tax rate is to subtract refunds of corporation income-tax as a per cent of gross collection from the assumed average statutory tax rate for the companies. The difference between the two may be taken as Effective Tax rate. Data on gross collection and refunds of corporation tax is available from Income Tax Statistics for a period of six years only from 1978-79 to 1983-84. Annual reports after 1983-84 are not

available. Similarly, data for the earlier period (1970-71 to 1977-78) are also not available in the published annual reports of the Income Tax Statistics. Furthermore, whatever information is available about gross collection and refund, it is for all companies together and not by class of companies. Estimated effective tax rate by this source for the period from 1978-79 to 1983-84 is shown in Table 4.1(b).

Table 4.1(b) : Effective Corporation Tax Rate Based on Net Collection, 1978-79 to 1983-84

(Rs. Crores)						
Year	Average Statutory Tax Rate inclusive of Surcharge	Gross Collection of Corporation Income Tax	Refunds from Gross Collection	Net Tax Collection	Refund as % of Gross Collection	Effective Tax Rate (Col. 2 - 6)
1	2	3	4	5	6	7
1978-79	57.8	1397	145	1252	10.4	47.4
1979-80	57.8	1587	195	1392	12.3	45.5
1980-81	59.1	1587	210	1377	13.2	45.9
1981-82	59.1	2214	244	1970	11.0	48.1
1982-83	56.4	2430	240	2190	9.9	46.5
1983-84	56.4	2855	362	2493	12.7	43.7

Source : Director of Inspection (Research, Statistics and Publication), New Delhi. All India Income Tax Statistics, 1978-79 to 1983-84.

The figures of net collection shown in col. 5 of Table 4.1(b) tally with the RBI's data on revenue from corporation tax in the corresponding period. This method suggests that

average effective tax rate varies between 44 and 48 per cent between 1978-79 and 1983-84. However, these data do not provide information required for working out effective tax rate by categories of companies viz., small and medium companies vis-a-vis large companies, industrial and trading companies, domestic and foreign companies and, within domestic companies, widely-held and closely-held companies. Such information, if available, would have proved very much useful in assessing the impact of corporation tax on different types of companies.

In brief, none of the above three methods for calculating effective tax rates is satisfactory because of inadequate information or lack of classification by categories of companies. At most, we may have a rough estimation of average effective tax rate for all the types of companies together. Furthermore, the ETR worked out by different methods do not tally with each other due to variation in the base information. However, among the three methods discussed above, the one using the RBI sample company data is fairly satisfactory in getting an idea of ETR for small and medium as well as large companies during the period under review.

4.3 Revenue Elasticity

In a developing economy, where corporate income is of great relative significance in national product, the importance of corporation tax as a source of revenue may be

expected to increase in absolute as well as relative terms. Table 2.3 shows the absolute amount of corporation tax (net) for the period 1970-71 to 1989-90 and the share of corporation tax as per cent of NDP at factor cost at current prices. It will be seen that over the period of 20 years under review, corporation tax collection increased from Rs. 371 crores to Rs. 4755 crores. The increase in corporation tax in absolute terms over the period works out to 12.8 times as compared to 1970-71. The share of corporation tax in total direct taxes is around 50 per cent and in total Union tax revenue is around 12 per cent during recent years. However, the share of corporation tax in the Net Domestic Product at factor cost at current prices did not show any significant change. It was moving up and down within a limited range of 1.07 per cent to 1.53 per cent of NDP.

Corporation income tax also emerges as an elastic source of revenue. Revenue elasticity of a tax can be defined as the ratio of change in the revenue of that particular tax with the change in the total tax revenue of that class of taxes or the total tax revenue from all taxes together. Table 4.2 shows revenue elasticity of corporation tax in India in relation to Total Direct Tax Revenue (DTR) in col. 6 and also in relation to Total Union Tax Revenue (UTR) in col. 9. Formula used to calculate revenue elasticity of Corporation Tax Revenue (CTR) is

Table 4.2 : Revenue Elasticity of Corporation Tax in India, 1970-71 to 1989-90

(Rs. Crores)								
Year	Revenue from Corporation Tax (CTR)	Change Over Previous Year (Δ CTR)	Total Direct Tax Revenue (TDTR)	Change over Previous Year (Δ TDTR)	Revenue Elasticity of Corporation Tax with Direct Tax $\frac{\Delta CTR}{\Sigma CTR} \div \frac{\Delta DTR}{\Sigma DTR}$	Total Union Tax Revenue (TUTR)	Change over Previous Year (Δ TUTR)	Revenue Elasticity of Corporation Tax in relation to TUTR $\frac{\Delta CTR}{\Sigma CTR} \div \frac{\Delta TUTR}{\Sigma TUTR}$
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
1970-71	371	-	870	-	-	2810	-	-
1971-72	472	101	1047	177	1.29	3389	579	1.28
1972-73	558	86	1238	191	1.00	3929	540	1.12
1973-74	583	25	1379	141	1.37	4431	502	1.23
1974-75	710	127	1650	271	1.09	5606	1175	0.84
1975-76	862	152	2205	555	0.67	6735	1129	1.05
1976-77	984	122	2328	123	2.44	7223	488	1.89
1977-78	1221	237	2406	78	6.67	7725	502	3.16
1978-79	1252	31	2528	122	0.5	9254	1529	0.14
1979-80	1392	140	2818	209	1.36	9436	182	5.46
1980-81	1377	-15	2998	180	-0.18	10394	958	-0.11
1981-82	1970	669	3764	766	1.81	12574	2180	2.10
1982-83	2185	215	4137	373	1.11	14189	1615	0.87
1983-84	2493	308	4497	360	1.57	16648	2459	0.82
1984-85	2556	63	4704	207	0.55	18925	2277	0.19
1985-86	2865	309	5626	922	0.64	22494	3569	0.66
1986-87	3160	295	6226	600	0.96	25915	3421	0.69
1987-88	3433	273	6746	520	1.24	29939	4024	0.57
1988-89	4407	974	8833	2087	0.93	35681	5742	1.44
1989-90	4755	348	10004	1171	0.61	40847	5166	0.69
(R.E.)								

$$RE_{CT} = \frac{\Delta CTR}{\Sigma CTR} \div \frac{\Delta DTR}{\Sigma DTR}$$

where CTR = Corporation Tax Revenue

DTR = Total Direct Tax Revenue, and

RE_{CT} = Revenue Elasticity of Corporation Tax.

Similarly, $RE_{CT} = \frac{\Delta CTR}{\Sigma CTR} \div \frac{\Delta UTR}{\Sigma UTR}$

where UTR = Total Union Tax Revenue.

Revenue elasticity of corporation tax in relation to total direct taxes and total Union taxes was greater than and less than 1, in the years mentioned below:

Revenue Elasticity of Corporation Tax	Years during which	
	RE > 1	RE < 1
a) In relation to total Direct Taxes	1971-72, 1972-73, 1973-74, 1974-75, 1976-77, 1977-78, 1979-80, 1981-82, 1982-83, 1983-84, 1987-88	1975-76, 1978-79, 1984-85, 1985-86, 1986-87, 1988-89, 1989-90
b) In relation to Total Union Tax Revenue	1971-72, 1972-73, 1973-74, 1975-76, 1976-77, 1979-80, 1981-82, 1988-89	1974-75, 1977-78, 1978-79, 1980-81, 1982-83, 1983-84, 1984-85, 1985-86, 1986-87, 1987-88, 1989-90

The above information suggests that change in corporation tax revenue was greater than change in the direct tax revenue during 11 out of 19 years under review. Whereas during remaining 8 years, corporation tax revenue changed

less than proportionate to change in total direct tax revenue. In relation to total Union tax revenue, elasticity of corporation tax was greater than 1 in eight out of 19 years but it was less than 1 in remaining 11 years.

We can draw an inference that contribution of corporation tax to direct tax revenue is significant but the share of corporation tax in the total Union tax revenue might be insignificant. It seems quite natural because the share of corporation tax in total direct tax revenue ranges between 40 and 50 per cent during the period under review but its share in Union taxes ranges between 11.5 and 15.8 per cent only.

4.4 Income Elasticity

Income elasticity of corporation tax can be defined as the ratio of change in tax to change in the income or profits before tax of the corporation. Income elasticity of corporation tax can be used to measure the responsiveness of the tax to changes in income. By using RBI data for the period from 1980-81 to 1988-89 for small and medium companies and large companies, we can see year to year changes in the income elasticity of corporation tax on small and medium as well as large companies.

Formula used in arriving at income elasticity of corporation tax is

Table 4.2(a) : Income Elasticity of Corporation Income-Tax as a Ratio of Change in Tax Paid to Change in Profit Before Tax, 1980-81 to 1988-89

(Amount in Rs. Crores)

Year	Small and Medium Companies					Large Companies				
	PBT	ΔPBT	Tax Paid	ΔT	Income Elasticity of Corporation Tax	PBT	ΔPBT	Tax Paid	ΔT	Income Elasticity of Corporation Tax
1	2	3	4	5	6	7	8	9	10	11
1980-81	1622	-	706	-	-	1222	-	518	-	-
1981-82	1665	43	730	24	1.30	1374	152	558	40	0.90
1982-83	1599	-66	589	-41	5.34	1204	-170	427	-131	2.25
1983-84	1296	-303	639	50	-0.10	1086	-118	468	41	-0.89
1984-85	1735	439	787	148	1.06	1504	418	585	117	0.69
1985-86	2137	402	856	69	0.40	1714	210	663	78	0.96
1986-87	1696	-441	731	-125	1.07	1465	-249	510	-1153	1.66
1987-88	1437	-259	787	56	-0.08	1399	-65	566	56	-0.60
1988-89	N.A.	-	-	-	-	2180	1411	726	160	0.43

Note : PBT = Profit before tax. ΔT = Change in tax paid over previous year.

Source: R.B.I. Reports on Currency and Finance for the respective years.

$$EY_{CT} = \frac{\Delta CT}{\Sigma CT} \div \frac{\Delta PBT}{\Sigma PBT}$$

where, EY_{CT} = Income elasticity of corporation tax,

CT = Total amount of corporation tax paid by the companies,

PBT = Profit before tax.

It can be seen from Table 4.2(a) that income elasticity of corporation tax in respect of small and medium companies is greater than large companies, throughout the period excepting years 1985-86 and 1986-87. This phenomenon suggests that large companies contribute less revenue to the state exchequer out of net addition to their income than the small and medium companies. It can also be seen that whenever there is a decline in the income, along with a fall in tax payment, tax amount declined sharply than the decline in profit before tax. The years 1982-83 and 1986-87 for small and medium corporations as well as for large corporations show this tendency. In the years 1983-84 and 1987-88, there was reduction in profits before tax with a net increase in tax paid by both the types of companies. This shows a negative income elasticity of tax less than unity.

Income elasticity of a tax gives us an idea about the changes required in the income or profits before tax of companies in order to collect a given amount of additional tax revenue.

Income elasticity of corporation tax by category of

companies would be more useful to assess the effect of income change on the liability of different companies to pay the corporation tax. The data on All India Income Tax Statistics, published by the Director of Inspection (Research, Statistics and Publications), New Delhi, which we have already used for estimating ETR, can also be used for calculation of income elasticity of corporation tax by categories of companies. Table 4.2(b) presents income elasticity of corporation tax for (i) widely-held domestic companies, (ii) closely-held domestic companies, (iii) foreign companies, and (iv) all companies for a period of eight years from 1974-75 to 1981-82. Information for the later period i.e. from 1982-83 onwards is not available for the reasons mentioned earlier.

Using the formula

$$EY_{CT} = \frac{\Delta CT}{\Sigma CT} \div \frac{\Delta Y}{\Sigma Y}$$

we can calculate income elasticity of corporation tax on the basis of available data. This exercise is done in Table 4.2(b).

It can be seen from Table 4.2(b) that during the period of eight years, from 1974-75 to 1981-82, income elasticity of corporation tax varied between 0.45 and 1.65 in relation to widely-held domestic companies. The range of variation in income elasticity was narrower for closely-held domestic companies where elasticity varied between 0.73 and 1.17 but was closer to unity. Income elasticity for foreign companies was at 2.35 and 2.04 in 1976-77 and 1977-78. During the remaining years it varied between 0.91 and 1.56.

Table 4.2(b) : Income Elasticity of Corporation Tax by Categories of Companies, 1974-75 to 1981-82

(Amounts in Rs. Crores)

Year	No. of Assessments	Income Assessed	Change in Income	Tax Demand	Change in Tax Demand	Income Elasticity
<u>Widely-held Domestic Companies</u>						
1974-75	2217	459	-	265	-	-
1975-76	3483	609	150	346	81	0.95
1976-77	3548	626	17	362	16	1.65
1977-78	3442	774	148	445	83	0.45
1978-79	2863	1056	282	591	146	1.43
1979-80	3001	1585	529	801	210	1.15
1980-81	2860	1152	(-)443	661	(-)140	0.61
1981-82	2736	1154	2	580	(-) 81	(-)72.2
<u>Closely-held Domestic Companies</u>						
1974-75	8020	198	-	119	-	-
1975-76	8855	182	(-) 16	110	(-) 9	0.96
1976-77	8617	169	(-) 13	104	(-) 6	0.73
1977-78	9679	177	8	110	6	1.17
1978-79	7405	193	16	120	10	1.00
1979-80	7434	293	100	188	68	1.07
1980-81	7004	183	(-)110	114	(-) 74	1.06
1981-82	7062	287	104	175	61	0.95
<u>Foreign Companies</u>						
1974-75	689	41	-	28	-	-
1975-76	966	57	16	40	12	1.08
1976-77	1454	92	35	65	25	2.35
1977-78	1464	87	(-) 5	58	(-) 7	2.04
1978-79	1189	97	10	64	6	0.91
1979-80	1201	142	45	86	22	1.02
1980-81	1241	129	(-) 13	74	(-) 12	1.56
1981-82	1130	83	(-) 46	47	(-) 27	1.03
<u>All Companies</u>						
1974-75	10926	698	-	409	-	-
1975-76	13304	847	149	496	87	1.00
1976-77	13619	886	39	532	36	1.56
1977-78	14585	1038	152	612	80	0.89
1978-79	11457	1346	308	775	163	0.91
1979-80	11636	2020	574	1075	300	0.95
1980-81	11105	1464	(-)556	850	(-)225	0.73
1981-82	10928	1523	59	802	(-) 48	(-)1.46

Income Elasticity of CT

$$EY_{CT} = \frac{\Delta CT}{\Sigma CT} + \frac{\Delta Y}{\Sigma Y}$$

Source : ^{Pub.} Directorate of Inspection (Research, Statistics and Publication), New Delhi.
Annual All India Income Tax Statistics for the respective years.

Foreign companies experienced wide range of fluctuations in the income elasticity of tax which suggests that the tax paid by foreign companies was highly sensitive to the changes in their income. Widely-held domestic companies stand next to foreign companies regarding sensitiveness of income-change to their tax liability. Closely-held domestic companies enjoyed fairly stable income elasticity of corporation tax. The reason might be proper tax planning by such companies with a view to maximize benefits from available tax concessions deductions and allowances. To make it sure, further research in the matter is necessary.

4.5 Incidence of Corporation Income Tax

One would need to go into the facts of the situation and decide the question of the incidence of the tax empirically.³ This is necessary to find out the right answer to the question who finally bears the corporation tax in India? Certain spokesmen of the private sector contend that in India the corporation tax is neither shifted forward nor backward but it basically falls on the retentions of the companies or ultimately on the companies because of shyness of equity market. On the contrary, American businessmen feel that the corporation tax in the United States is treated by them as an element of the cost of production and, therefore, passed on forward to the consumers in the form of higher prices. These conflicting opinions of businessmen operating under different economic environments confuse the issue still

further and highlight the need for an empirical investigation into this area. In the present study, we have used the data from Reserve Bank of India sample companies (large, and small and medium scale) from 1970-71 to 1989-90. [See Tables 4.1 and 4.3(a) and (b).]

We tried to find out who, amongst the following, bears the burden of corporation tax in India: consumers, stockholders, factor owners, the companies themselves.

In the past, some writers analysed the index of corporate profits-before-tax in relation to the rising corporation tax rate over time. The logic of this index was as follows: (i) if with a rise in the corporation tax rate, the index of corporate profit-before-tax increased proportionately, the indication was that tax was fully passed on (forward shifting), (ii) if this index remained constant, it implied that the tax was absorbed by the corporate earnings. M.A. Adelman, Rotchford and Han, V.D. Lall, Ambirajan, studied the question of shifting.⁴ V.D. Lall concluded that the corporation tax in India was shifted backward to labour. Similarly, Ambirajan⁵ analysed the trends in the index numbers of wholesale prices of consumer and manufactured goods, cost of materials and labour earnings along with the trends in the corporation tax rates. He concluded that the corporation tax in India might not have been shifted during the period from 1951 to 1960.

Recently, Kryzaniak and Musgrave tried to solve this

problem of incidence by using the econometric tools and a multiple regression model. Laumas also attempted to apply the Kryzaniak and Musgrave profit equation to the data of the India's corporate sector published by the Reserve Bank of India. V.P. Gandhi and V.G. Rao also used the Reserve Bank of India's small and medium-scale sample companies data for the elaboration of incidence of corporation Income Tax in India. V.P. Gandhi⁶ proposed some selected indicators of different incidences. These are:

- (1) The ratio of profits-after-tax (PAT) to net worth (NW) as an indirect indicator of the shifting of the corporation tax to the consumer ($\frac{PAT}{NW}$ = forward shifting).
- (2) The ratio of dividends (D) to the paid-up capital (K) as an indicator of shifting the incidence of the corporation tax to shareholders.
- (3) The ratio of retained earnings (RE) to profits-after-tax as an indicator of the incidence on the companies. Companies try to save tax burden by retaining a larger proportion of earnings, when the tax rate is high.

Table 4.3(b) shows the results obtained by using some of the indicators of incidence for the years 1970-71 to 1987-88.

Table 4.3 : Allocation of Profits Before Tax by the Sample Companies of the RBI During 1970-71 to 1987-88

Year	Number of Companies	Paid-up Capital	Allocation of Profits (Per cent)		
			Tax	Dividends	Retained Profits
(1)	(2)	(3)	(4)	(5)	(6)
1970-71	1650	1541	41.6	27.2	31.2
1971-72	1650	1593	45.3	27.4	27.3
1972-73	1650	1645	46.8	28.0	25.2
1973-74	1650	1706	47.8	21.3	30.9
1974-75	1650	1808	48.9	15.2	35.9
1975-76	1650	1899	59.0	23.5	17.5
1976-77	1720	1992	59.2	25.1	15.7
1977-78	1720	2147	57.1	25.2	17.7
1978-79	1720	2269	51.1	23.5	24.4
1979-80	1720	2357	46.7	20.1	33.2
1980-81	1800	2788	43.5	21.0	35.5
1981-82	1800	2969	43.8	22.1	34.1
1982-83	1838	3246	36.8	23.9	39.3
1983-84	1838	3476	49.3	30.7	20.0
1984-85	1838	3637	48.1	28.7	23.2
1985-86	1953	N.A.	40.1	26.2	33.7
1986-87	1953	5236	43.1	36.1	20.8
1987-88	1953	4496	54.8	50.3	-5.1

- Sources:**
- 1) RBI. Report on Currency and Finance, Vol. II, 1975-76, p. 76.
 - 2) RBI. Report on Currency and Finance, Vol. II, 1980-81, p. 73.
 - 3) RBI. Report on Currency and Finance, Vol. II, 1984-85, p. 76.
 - 4) RBI. Report on Currency and Finance, Vol. II, 1986-87, p. 74.
 - 5) RBI. Report on Currency and Finance, Vol. II, 1989-90, p. 122.

Table 4.3(a) : Sales, Profits and Tax - Medium and Large Companies in the Private Sector

	(Rs. Crores)																	
Year	1970-71	1971-72	1972-73	1973-74	1974-75	1975-76	1976-77	1977-78	1978-79	1979-80	1980-81	1981-82	1982-83	1983-84	1984-85	1985-86	1986-87	1987-88
Number of Companies (Small and Medium)	1650	1650	1650	1650	1650	1650	1720	1720	1720	1720	1800	1800	1838	1838	1838	1953	1953	1953
1) Sales	6901 (100)	7749 (100)	8598 (100)	9356 (100)	11811 (100)	13171 (100)	14511 (100)	15824 (100)	17564 (100)	20268 (100)	23736 (100)	25442 (100)	33112 (100)	35723 (100)	41222 (100)	47659 (100)	51844 (100)	57100 (100)
2) Profits Before Tax	535 (7.7)	565 (7.3)	598 (6.9)	740 (7.9)	1021 (8.6)	800 (6.0)	823 (5.6)	893 (5.6)	1102 (6.2)	1424 (7.0)	1622 (6.8)	1665 (6.5)	1599 (4.8)	1296 (3.6)	1574 (3.8)	2137 (4.5)	1696 (3.3)	1437 (2.5)
3) Tax Provision	223 (3.2)	256 (3.3)	280 (3.2)	354 (3.7)	499 (4.2)	472 (3.6)	487 (3.3)	510 (3.2)	563 (3.2)	665 (3.3)	706 (3.0)	730 (2.9)	589 (1.8)	639 (1.8)	756 (1.8)	856 (1.8)	731 (1.3)	787 (1.4)
4) Dividends	145 (2.1)	155 (2.0)	168 (1.9)	157 (1.6)	155 (1.3)	188 (1.4)	207 (1.4)	225 (1.4)	259 (1.5)	287 (1.4)	340 (1.4)	368 (1.4)	382 (1.2)	398 (1.1)	453 (1.1)	561 (1.2)	613 (1.2)	723 (1.3)
5) Retained Profits	167 (2.4)	154 (1.9)	151 (1.7)	229 (2.4)	367 (1.3)	140 (1.0)	130 (0.8)	158 (1.0)	280 (1.6)	472 (2.3)	576 (2.4)	567 (2.2)	628 (1.9)	259 (0.7)	365 (0.9)	721 (1.5)	352 (0.7)	-73 (-0.1)
Number of Companies (Large)						404	404	426	426	426	486	486	486	541	541	581	622	622
1) Sales						9055 (100)	10222 (100)	10947 (100)	12218 (100)	14090 (100)	17013 (100)	20440 (100)	22495 (100)	25705 (100)	29838 (100)	34114 (100)	34049 (100)	37764 (100)
2) Profits Before Tax						669 (7.4)	716 (7.0)	744 (6.8)	894 (7.3)	1121 (8.0)	1222 (7.2)	1374 (6.7)	1290 (5.7)	1154 (4.5)	1441 (4.8)	1814 (5.3)	1465 (4.3)	1399 (3.7)
3) Tax Provision						362 (4.0)	382 (3.7)	402 (3.7)	441 (3.3)	521 (3.7)	518 (3.0)	558 (2.7)	434 (1.9)	487 (1.9)	571 (1.9)	643 (1.9)	510 (1.5)	566 (1.5)
4) Dividends						153 (1.7)	171 (1.7)	191 (1.7)	218 (1.8)	241 (1.7)	271 (1.6)	302 (1.5)	314 (1.4)	329 (1.3)	393 (1.3)	467 (1.4)	454 (1.3)	546 (1.4)
5) Retained Profits						155 (1.7)	163 (1.6)	151 (1.4)	235 (1.9)	359 (2.5)	434 (2.6)	515 (2.5)	542 (2.4)	338 (1.3)	477 (1.6)	704 (2.1)	501 (1.5)	288 (0.8)

Sources : 1) R.B.I. Report on Currency and Finance (Vol. II), 1977-78, p. 67.
 2) R.B.I. Report on Currency and Finance (Vol. II), 1983-84, p. 75.
 3) R.B.I. Report on Currency and Finance (Vol. II), 1984-85, p. 76.
 4) R.B.I. Report on Currency and Finance (Vol. II), 1986-87, p. 74.
 5) R.B.I. Report on Currency and Finance (Vol. II), 1987-88, p. 78.
 6) R.B.I. Report on Currency and Finance (Vol. II), 1989-90, p. 122.

Table 4.3(b) : Indicators of Incidence of Corporation Tax in India, 1970-71 to 1987-88

Year	1970-71	1971-72	1972-73	1973-74	1974-75	1975-76	1976-77	1977-78	1978-79	1979-80	1980-81	1981-82	1982-83	1983-84	1984-85	1985-86	1986-87	1987-88
Number of Companies	1650	1650	1650	1650	1650	1650	1720	1720	1720	1720	1800	1800	1838	1838	1838	1953	1953	1953

INDICATORS

1. Ratio of Profits After Tax to Net Worth: PAT/NW	11.6	10.8	10.4	11.6	<u>13.7</u>	8.2	8.3	8.8	11.5	<u>14.5</u>	<u>14.5</u>	<u>13.0</u>	<u>12.0</u>	10.0	7.1	8.3	5.7	3.5
2. Ratio of Dividends to the Paid-up Capital: D/K	9.4	9.7	10.2	9.2	8.6	9.9	10.4	10.5	11.4	12.2	12.2	12.4	11.8	11.4	12.5	13.2	13.2	13.8
3. Ratio of Retained Earnings to Profits-Before-Taxes: RE/PBT	31.2	27.3	25.3	30.9	35.9	17.5	15.8	17.7	25.4	33.1	35.5	34.1	39.3	20.0	23.2	33.7	20.7	-5.1
4. Ratio of Retained Earnings to Profits-After-Tax : RE/PAT	<u>53.5</u>	49.8	47.5	<u>59.3</u>	<u>70.3</u>	42.7	38.7	41.2	<u>52.0</u>	<u>62.2</u>	<u>62.9</u>	<u>60.6</u>	<u>62.2</u>	27.0	44.6	<u>56.3</u>	36.47	-11.2
5. Ratio of Tax Provision to Profits-Before-Tax: T/PBT	41.7	45.3	46.8	47.8	48.9	59.0	59.2	57.1	51.1	46.7	43.5	43.8	36.8	49.3	48.1	40.1	43.1	54.7

- Sources : 1) R.B.I. Report on Currency and Finance (Vol. II), 1977-78, p. 67.
 2) R.B.I. Report on Currency and Finance (Vol. II), 1983-84, p. 75.
 3) R.B.I. Report on Currency and Finance (Vol. II), 1984-85, p. 76.
 4) R.B.I. Report on Currency and Finance (Vol. II), 1986-87, p. 74.
 5) R.B.I. Report on Currency and Finance (Vol. II), 1987-88, p. 78.
 6) R.B.I. Report on Currency and Finance (Vol. II), 1989-90, p. 122.

- (i) The indicator $\frac{PAT}{NW}$ shows that the sample companies could presumably shift a part of the burden on to the consumers during the years 1974-75 and 1979-80 to 1982-83, because the ratio was higher during these years.
- (ii) The second indicator D/K shows that during the period from 1970-71 to 1973-74, 1975-76 to 1978-79 and finally 1983-84 to 1987-88, the incidence was shifted to shareholders because ratio of dividends to capital employed during these years was relatively less.
- (iii) A part of the burden as shown in indicator No.3, RE/PBT during the years 1972-73, 1975-79, and 1983-84 to 1984-85 was borne by the companies themselves as the ratio was lower in these years. A lower RE/PBT ratio would mean decrease in net worth of the company resulting in fall in the market prices of company securities.
- (iv) The indicator RE/PAT suggests that major tax burden in the years 1970-71, 1973-74, 1974-75, 1978-79 to 1982-83 and in 1985-86 was shifted to the shareholders as indicated by the high ratio of retained earnings to profits-after-tax. In rest of the years, the burden was borne by the companies.

(v) The indicator T/PBT is nothing but the effective corporate tax rate. It suggests only formal incidence on the companies but it does not suggest anything about final incidence. Some non-tax factors like per capita income, rate of inflation, production cost, wage level, etc., may shift the incidence either forward or backward. Rise in per capita income or in wage level would increase purchasing power with the people enabling corporations to shift the tax forward. On the other hand, a high rate of inflation and rise in the cost of production would discourage household demand resulting in backward shifting of tax to the owners of factor resources.

4.6 Impact of Corporation Tax

In India, income (profits) from all sources has been accepted as a base of corporation tax. We have a flat rate system since the introduction of this tax, with minor changes from time to time through various Finance Acts, as discussed in earlier chapters of the present work. Many economists have argued that Indian corporations are subject to heavy Corporate Income Tax as compared to other developed as well as developing countries in the world. While in India, the maximum statutory tax rate on companies varies between 60 per cent and 75 per cent (sur-tax included), in

other developed countries of the world, the tax-rate is as follows: 12.5 per cent in Hongkong, 18.7 per cent in United Arab Republic, 20 per cent in Turkey and 25 per cent in Korea, Laos and Thailand. The maximum rate of Corporation Tax in Canada, France, Iran, New Zealand, Pakistan, Kuwait, Austria and United Kingdom varied between 50 and 54 per cent.⁷ The maximum corporation tax rates in India, thus are higher than many other countries. Besides the heavy rates, there is surcharge also (e.g. surcharge on excess profits was between 2.5 and 7.5 per cent). Through the levy of surcharge, some degree of progression is brought in the tax. It is simply a point of criticism that in the country, where rapid industrialization is the need of the hour, it is thought that such a heavy taxation would have adverse effects on savings and investment in corporate sector.

(i) Impact on Corporate Savings: Earlier studies of S. Ambirajan over the period 1939-51 and 1951-59 suggested that the tax provision increased from 3.1 per cent of the total sales to 4.4 per cent over the former period, whereas retained profits plus depreciation remained virtually constant at 6.5 per cent. The increased tax provision can only be had by a reduction in dividends as a percentage of sales, from 6.2 per cent in 1939 to 3.3 per cent in 1951.

During the later period i.e. 1951 to 1959, though the profits were slightly increasing, tax provision and dividend distribution were held constant. However, there

was no marked upward rise in corporate savings. On the basis of this study, Ambirajan concluded that a rise in corporation tax would be only "at the expense of retained earnings".

To examine the validity of Ambirajan's findings in the context of present situation, an analysis of the data of RBI sample companies, relating to changes in the corporate savings in response to changes in the provisions of Indian Corporation Tax for the period from 1970-71 to 1989-90 has been done. [See Table 4.3(a).]

The two sources of savings for the private corporate sector are retained profits and depreciation provision.

$$\text{Retained Profits} = \text{Gross Profits} - [\text{Taxes on Income} + \text{Dividends}]$$

or

$$\text{Retained profits} = \text{Profits-after-tax} - \text{Dividend}$$

$$\text{RE} = \text{PAT} - \text{D.}$$

In brief, whatever remains in the hands of corporations after paying taxes and dividends from gross profits is the amount of retained profits or savings of the company. Retained profits are internal sources of finance for business corporations.

It is clear that corporations can increase their savings only if the taxes and dividends are low. Higher the rate of corporation Income Tax, ceteris paribus, lower will be the amount of retained profits. If the private

corporate sector is bent upon paying a fairly stable amount of dividends, then a rise in the rate of corporation tax, given pre-tax profits would adversely affect the amount of retained profits in the hands of corporate sector. Available information of the sample companies for the period under our study reveals that a stable dividend policy was not followed by Indian companies; therefore, Ambirajan's contention of inverse relationship between Corporation Tax rate and retained earnings did not hold good. Even the dividend policy of the companies was affected by changes in the effective tax-rate. For instance, in 1973-74 and 1974-75, rise in corporate tax rate coincided with increased retained earnings of the companies, of course, at the cost of reduced dividends (see Table 4.3). In 1987-88, companies paid tax at the rate of 54.8 per cent, highest ever since 1970-71 and still paid dividends equal to 50.3 per cent of PBT. Retained earnings were negative (-5.1 per cent).

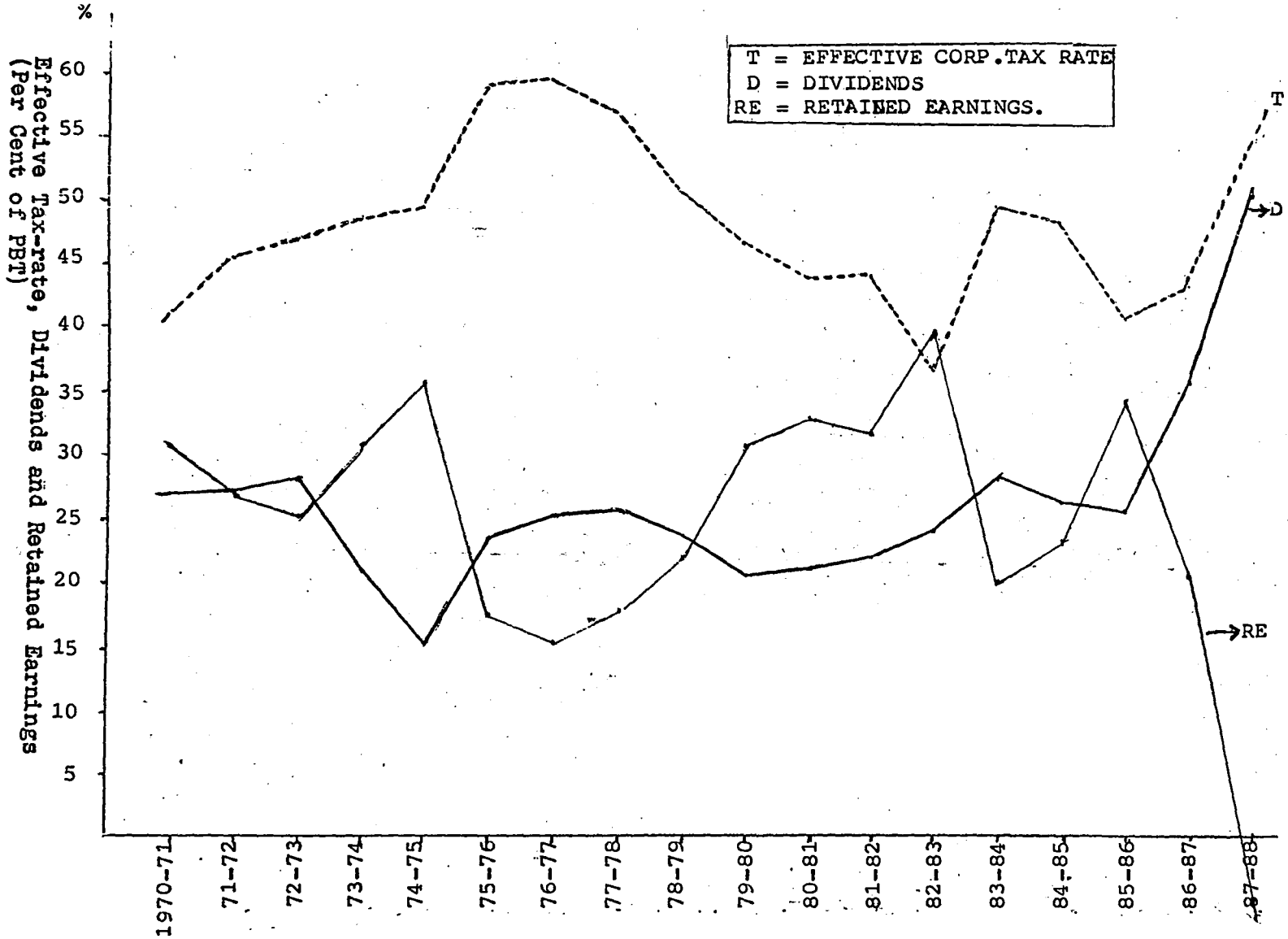
V.G. Rao, in his work "The Corporation Income Tax in India", has come to the conclusion that in spite of increase in corporate tax liability and cyclical fluctuations in gross profits, the share of dividend payments remained fairly stable (around 30 per cent) and, therefore, any change in the effective corporation tax-rate affected the amount of retained profits only. Actually, however, dividend distribution during the period from 1970-71 to 1987-88 fluctuated between 15 per cent and 50 per cent of PBT. As such, the

contention of Rao is not corroborated by the empirical evidence for the period under study. However, it can be argued that retained earnings and corporation tax are inversely related over a period of time. A trend diagram showing year-to-year fluctuations in effective tax rate (T), retained earnings (RE) and dividend (D) is given in Figure 4.1.

The change in Corporate Income Tax brings about inverse change either in the corporate savings or in the policy of dividend distribution.

Table 4.4 shows the estimates of net domestic savings and share of private corporate sector in total domestic savings. For the period from 1970-71 to 1987-88 share of private corporate sector in total domestic savings was decreasing; as a percentage of Net National Product at current market prices it is less than 1.0 per cent (average 0.45 per cent during the period under study). There are year-to-year fluctuations in the absolute amount as well as in the relative share of private corporate sector in total domestic savings and as per cent of NNP at market prices. The share of private corporate sector has invariably declined during those years in which effective corporation tax rate was higher.⁸ For instance, in the years 1975-76, 1976-77, and 1983-84, effective tax-rate was higher resulting in reduced share of private corporate sector in total domestic savings. This shows a negative relationship between ETR

Figure 4.1 : Year-to-year Fluctuations in Tax Rate, Dividends and Retained Earnings of Small and Medium Sample Companies, 1970-71 to 1987-88



and RE of the domestic private companies. ETR started rising sharply after 1985-86. In 1987-88 both ETR and dividends were as high as 54.8 and 50.3 per cent of PBT respectively, resulting in negative retained earnings at 5.1 per cent.

Savings of the corporate sector in absolute terms at current prices rose from Rs. 227 crores in 1970-71 to Rs. 1342 crores in 1985-86, recording a rise of 591 per cent. However, the relative share of private corporate sector in total domestic savings has shown year-to-year fluctuations ranging between -0.5 to 4.9 per cent by 1987-88. The share of domestic private corporate sector fell further to 2.5 per cent in 1986-87 and in 1987-88, it was negative by a small amount of Rs. 145 crores or 0.5 per cent of the domestic savings in that year. High-tax rate combined with high dividend payments appear to be the main reasons for decline in total domestic savings and share of private corporate sector therein.

From the above discussion, we may conclude that even if we study the problem of corporate savings at macro level, we find that the share of private corporate sector in total domestic savings was subject to fluctuations depending upon, among other factors, the rate of corporation tax. The higher the effective corporation tax rate, ceteris paribus, lower is the corporate profits after tax and the share of corporate savings in the total domestic savings.

Table 4.4 : Estimates of Net Domestic Savings, Savings of Domestic Private Corporate Sector in the Total Domestic Savings and Net National Product at Current Market Prices

	(Rs. Crores)																	
Year	1970-71	1971-72	1972-73	1973-74	1974-75	1975-76	1976-77	1977-78	1978-79	1979-80	1980-81	1981-82	1982-83	1983-84	1984-85	1985-86	1986-87	1987-88
Saving Sectors																		
1. Public Sector	804 (17.6)	689 (17.0)	825 (18.0)	1335	2489 (25.8)	2493 (23.1)	3506 (25.2)	3513 (22.8)	3951 (21.0)	3125 (16.6)	2631 (12.4)	4639 (19.6)	4468 (17.3)	2475 (8.4)	1657 (4.9)	-2931 (-10.7)	-5454 (-20.6)	-8081 (-27.0)
Per Cent of NNP at Market Prices	0.1	1.9	2.1	2.4	3.8	3.6	4.6	4.2	4.4	3.1	2.2	3.4	2.9	1.5	0.8	-1.2	-1.9	-2.7
2. Domestic Private Corporate Sector	227 (5.0)	195 (4.8)	216 (4.7)	381	593 (6.2)	188 (1.7)	229 (1.7)	350 (2.3)	452 (2.4)	781 (4.1)	891 (4.2)	745 (3.2)	722 (2.7)	504 (1.7)	874 (2.6)	1342 (4.9)	662 (2.5)	-145 (-0.5)
Per cent of NNP	0.6	0.6	0.6	0.7	0.9	0.3	0.3	0.4	0.5	0.8	0.7	0.5	0.5	0.3	0.5	0.6	0.2	-0.05
*3. Household Sector (Net)	3535 (77.4)	3178 (78.2)	3554 (77.3)	N.A.	6558 (68.0)	8119 (75.2)	10151 (73.1)	11528 (74.9)	14397 (76.6)	14978 (79.3)	17750 (83.4)	18277 (77.2)	20705 (80.0)	26656 (89.9)	31160 (92.5)	28920 (105.8)	31329 (118.1)	38169 (127.5)
Per Cent of NNP	9.4	8.8	9.0		10.0	11.5	13.5	13.7	15.8	15.0	14.8	13.2	13.5	14.8	15.8	12.2	11.8	12.8
4. Total Domestic Net Savings (1 + 2 + 3)	4566 (100.0)	4062 (100.0)	4595 (100.0)	N.A.	9640 (100.0)	10800 (100.0)	13886 (100.0)	15391 (100.0)	18800 (100.0)	18884 (100.0)	21272 (100.0)	23661 (100.0)	25895 (100.0)	29635 (100.0)	33691 (100.0)	27331 (100.0)	26537 (100.0)	29943 (100.0)
Per Cent of NNP	12.1	11.3	11.7		14.7	15.5	18.4	18.3	20.8	18.9	17.8	17.2	16.9	16.4	16.9	11.6	10.1	10.0

Notes : 1) *Household Sector Savings are adjusted by subtracting Public Sector and Corporate Sector Savings from Total Domestic Savings.

2) Figures in brackets indicate per cent of total Domestic Net Savings.

Sources : 1) R.B.I. Report on Currency and Finance, Vol. I, 1979-80, pp. 5-6.

2) R.B.I. Report on Currency and Finance, Vol. II, 1979-80, pp. 6, 14-15.

3) R.B.I. Report on Currency and Finance, Vol. II, 1983-84

4) R.B.I. Report on Currency and Finance, Vol. II, 1986-87, pp. 6, 12-13.

5) R.B.I. Report on Currency and Finance, Vol. II, 1989-90, pp. 6, 12-13.

and RE of the domestic private companies. ETR started rising sharply after 1985-86. In 1987-88 both ETR and dividends were as high as 54.8 and 50.3 per cent of PBT respectively, resulting in negative retained earnings at 5.1 per cent.

Savings of the corporate sector in absolute terms at current prices rose from Rs. 227 crores in 1970-71 to Rs. 1342 crores in 1985-86, recording a rise of 591 per cent. However, the relative share of private corporate sector in total domestic savings has shown year-to-year fluctuations ranging between -0.5 to 4.9 per cent by 1987-88. The share of domestic private corporate sector fell further to 2.5 per cent in 1986-87 and in 1987-88, it was negative by a small amount of Rs. 145 crores or 0.5 per cent of the domestic savings in that year. High-tax rate combined with high dividend payments appear to be the main reasons for decline in total domestic savings and share of private corporate sector therein.

From the above discussion, we may conclude that even if we study the problem of corporate savings at macro level, we find that the share of private corporate sector in total domestic savings was subject to fluctuations depending upon, among other factors, the rate of corporation tax. The higher the effective corporation tax rate, ceteris paribus, lower is the corporate profits after tax and the share of corporate savings in the total domestic savings.

(ii) Impact on Investment: It is difficult to find out the effects of corporation income-tax on the aggregate investment in the economy. A major portion of investment in Indian economy is made in the public sector where profit motive is almost subsidiary. Even for the private sector, changes in investment can hardly be attributed to a change in tax rate alone as there are several reasons, economic and non-economic, affecting corporate investment other than taxation. Even then, a major criticism advanced against the corporation income tax has been that such a tax will have an adverse effect upon private sector investment. The adverse effect may occur as a result of the curtailment of the incentives or reduction in the ability to invest. James Cutt⁹ has opined that the disincentive effect of tax on private corporate management in India is not so serious as is the effect of the tax on the ability to invest. A corporation income tax diminishes the funds available to corporations from both internal and external sources. The impact of the tax on retained profits is more direct than on the external sources of funds. This is particularly serious for those corporations which are in general more willing to undertake expansion with reserves rather than with borrowed funds. This effect may be particularly severe on new enterprises which may have greater difficulty in raising funds. These corporations may be the ones most likely to develop new products and new techniques. For such corporations, the

high tax rate may have a dampening effect on the development of new and risky ventures and help in protecting existing firms against competition, thereby strengthening their monopoly position.

We shall now examine the validity of the theoretical reasoning discussed above in the light of recent data regarding change in investment that can be noted through change in the gross fixed assets of the corporations. Table 4.5 shows the change in the value of gross fixed assets and the annual rate of change in respect of sample companies in the private sector (medium and large) covering a period from 1970-71 to 1987-88. Throughout the period, from 1970-71 to 1987-88, there has been a steady growth in the amount of gross fixed assets from Rs. 5,077 crores in 1970-71 to Rs.27,492 crores in 1984-85 and further to Rs.44,010 crores in 1987-88. Increase in absolute terms works out to 866.9 per cent during the period from 1970-71 to 1987-88. Table 4.5 analyses year-to-year growth of gross and net fixed assets of the sample companies during the period under review. Gross fixed assets increased every year with a minimum of

Table 4.5 : Change in Gross and Net Fixed Assets of Companies in the Private Corporate Sector

	(Rs. Crores)																		
Year	1970-71	1971-72	1972-73	1973-74	1974-75	1975-76	1976-77	1977-78	1978-79	1979-80	1980-81	1981-82	1982-83	1983-84	1984-85	1985-86	1986-87	1987-88	
Number of Companies (Small and Medium)	1650	1650	1650	1650	1650	1650	1720	1720	1720	1720	1800	1800	1838	1838	1838	1953	1953	1953	
a) Assets :																			
Gross Fixed Assets	5077	5483	5979	6525	7275	8044	8394	9213	10110	11137	14000	16309	19693	23182	27492	34719	39183	44010	
Percentage Change over Previous Year	-	8.0	9.0	9.1	11.5	10.6	4.4	9.8	9.7	10.2	25.7	16.5	20.7	17.7	18.6	26.3	12.8	12.3	
b) Net Fixed Assets	2814	2936	3130	3364	3771	4170	4399	4809	5242	5757	7748	9334	11943	14213	16966	22291	24958	27340	
Percentage Change over Previous Year	-	4.3	6.6	7.5	12.1	10.6	5.5	9.3	9.0	9.8	34.6	20.5	28.0	19.0	19.4	31.4	12.0	9.5	
c) Uses of Funds:																			
Gross Fixed Assets	-	376	467	525	691	747	624	743	856	1016	N.A.	2112	N.A.	2414	797	3278	3916	4234	
Percentage Change over Previous Year	-	-	24.2	12.4	31.6	8.1	-16.5	19.1	15.2	18.7	-	107.9	-	14.3	-67.0	413.8	19.46	8.1	
Number of Companies (Large)																			
							426	426	426	486	486	486	541	541	581	622	622		
a) Assets:																			
Gross Fixed Assets							7377	8097	8863	10321	12091	14447	18130	21481	26307	26909	30498		
b) Net Fixed Assets																			
							3887	4224	4579	5624	6869	8561	11268	13383	16987	17130	18998		
c) Uses of Funds:																			
Gross Fixed Assets							626	681	764	-	1597	2156	-	2414	2715	3182	3558		

Sources : 1) R.B.I. Report on Currency and Finance, Vol. II, 1975-76, p. 76.
 2) R.B.I. Report on Currency and Finance, Vol. II, 1980-81, p. 73.
 3) R.B.I. Report on Currency and Finance, Vol. II, 1986-87, p. 74.
 4) R.B.I. Report on Currency and Finance, Vol. II, 1987-88, p. 78.

4.4 per cent in 1976-77 and maximum of 26.3 per cent in 1985-86. Eliminating year-to-year variations, the average rate of growth in gross fixed assets works out to 13.7 per cent for the entire period under study.

If a change in net fixed assets is taken as net investment which shows wider fluctuations in response to changes in the basic tax-rate or deductions, concessions and allowances, we find that a minimum change of 4.3 per cent in the net fixed assets was recorded in 1971-72. Maximum increase in the net fixed assets was recorded in 1980-81 at 34.6 per cent.

Investment in fixed assets shows a steady growth of 8 to 10 per cent per annum from 1970-71 to 1979-80, though with slight variations. There was a sudden drop in the rate of growth of investment in fixed assets in 1976-77, 1981-82, 1983-84, 1986-87 and 1987-88 due to excessively high effective tax rate. The average rate of growth of investment in gross fixed assets between 1980-81 and 1984-85 works out to about 20 per cent; during the same period, the annual average rate of change in net fixed assets works out to over 24 per cent.

Between 1985-86 and 1987-88 there was a gradual decline in the rate of growth in fixed assets, both gross and net. Among others, one major reason was a high ETR and high dividend payments during the corresponding period.

Looking at the figures for purchase of gross fixed assets under the heading 'uses of funds', there seem to be larger increases in the years 1972-73, 1974-75, 1977-78, 1981-82 and 1983-84, in the amounts utilized for purchase of assets over the previous years. Every time, either a reduction in the effective tax rate or special deductions and allowances or concessions were responsible for increase in investment. We may, therefore, conclude, that tax provisions do have an impact on the investment by the business corporations through whatever sources of funds. Between the period from 1985-86 and 1987-88, purchase of gross fixed assets gradually increased even though the ETR and dividends were high and the retained earnings were rapidly declining. The internal sources associated with borrowed funds must have been used for purchase of fixed assets.

Another way of looking at the impact on investment is through the capital issued by the companies and pattern of absorption of capital issues by the public (in the stock-markets). It is believed that public is quite responsive to changes in company tax provisions, while buying or selling industrial securities in the stock-market. Companies also issue more capital in the years of prosperity and tax-reliefs. Table 4.6 shows the capital issued by non-Government Indian companies (new and existing) between 1970-71 and 1988-89. It will be seen from the Table that issue of share capital largely declined during the years 1976 and 1979 when

Table 4.6 : Capital Issued by Indian Companies between 1970-71 and 1988-89 (New and Existing)

	(Rs. Crores)														
	1970-71	1975-76	1976-77	1977-78	1978-79	1979-80	1980-81	1981-82	1982-83	1983-84	1984-85	1985-86	1986-87	1987-88	1988-89
Number of Companies issuing Capital	57	83	69	80	80	96	121	244	353	441	395	676	385	119	178
I. Share Capital (i) and (ii)	39.05	88.25	43.70	87.30	69.64	97.03	74.00	272.93	206.50	254.11	329.62	575.20	737.71	746.47	718.88
Of which:															
1) Equity	27.14	81.11	39.63	84.53	67.94	96.73	71.24	270.47	204.67	252.90	328.02	575.20	737.71	746.47	718.88
ii) Preference	11.91	7.14	4.07	2.77	1.70	0.30	2.76	2.46	1.83	1.21	1.60	-	-	-	-
II. Debentures	4.90	0.20	0.24	2.19	2.02	7.15	63.80	-	207.99	28.74	73.09	89.81	575.50	184.07	950.39
Total Issues (I and II)	43.95	88.45	43.94	89.49	71.66	103.18	137.80	272.93	414.49	282.85	402.71	665.01	1313.21	930.54	1669.27

- Sources : 1) R.B.I. Report on Currency and Finance, 1979-80, Vol. II, pp. 86, 92-96.
 2) R.B.I. Report on Currency and Finance, 1980-81, Vol. II, pp. 84, 90-94.
 3) R.B.I. Report on Currency and Finance, 1986-87, Vol. II, pp. 80, 96-97.
 4) R.B.I. Report on Currency and Finance, 1987-88, Vol. II, pp. 100-101.
 5) R.B.I. Report on Currency and Finance, 1989-90, Vol. II, pp. 112-113.

the effective tax-rate was high. Debenture issues, however, do not show any relationship with the tax rate. However, in the years 1983-84 and 1984-85, when the effective tax rate was relatively high, the amount of equity issues showed an exceptionally good response over the earlier year 1982-83. This might be because of the spurt in investment market created after simplification of tax structure. Total amount of issue of shares and debentures, in general, showed a continuously rising trend with the exception of the years 1976-77, 1978-79, 1983-84 and 1987-88 when effective tax rate increased suddenly.

Table 4.7 shows pattern of absorption of private capital issues during the period under review. The amount of issued capital appears to have been decreased during the years 1976-77, 1977-78, 1978-79 and 1983-84. This drop in public response was not compensated by promoters, Government and financial institutions as well. On the contrary, these agencies also contributed less to the subscribed capital in the face of poor response by the public. Public response to capital issues by the companies was good from the year 1977-78 onwards and was extraordinarily good in the year 1981-82 and 1984-85 onwards till 1988-89, though there was a little drop in 1987-88. Incidentally, these were the years of high security prices in India; for instance, index number of prices of industrial securities-ordinary shares (all industries) rose to 118.9 in 1981-82 in the immediately

Table 4.7 : Pattern of Absorption of Private Capital Issues, 1970-71 to 1988-89

		(Rs. Crores)														
Year		1970-71	1975-76	1976-77	1977-78	1978-79	1979-80	1980-81	1981-82	1982-83	1983-84	1984-85	1985-86	1986-87	1987-88	1988-89
No. of Companies Issuing Capital		57	83	69	80	80	96	121	244	353	441	395	676	385	119	178
1.	Amount Issued (I + II)	42.26	64.08	34.30	71.71	57.87	62.24	98.38	421.63	356.60	225.96	333.23	669.42	1268.99	562.97	1662.56
2.	I. <u>Subscribed:</u>	8.96	7.69	5.75	14.56	11.37	13.89	24.27	119.65	151.22	74.31	139.54	239.62	579.10	246.54	578.86
	1) By Promoters, Collaborators, Employees, etc.	8.75	5.79	4.40	10.32	9.41	10.68	22.11	103.39	142.11	63.83	88.04	195.99	304.63	215.38	474.51
	ii) By Government and Financial Institutions	0.21	1.90	1.35	4.24	1.96	3.21	2.16	16.26	9.11	10.48	51.50	43.63	274.47	31.16	104.35
	II. <u>Offered to Public</u>	33.30	56.39	28.55	57.15	46.50	48.36	74.10	301.98	205.38	151.65	193.69	429.80	689.89	316.43	1083.70
	1) Subscribed by the public other than underwriters	19.15	28.56	15.49	30.77	34.77	39.89	65.59	260.93	156.53	133.59	176.10	425.72	623.63	260.39	1014.32
	ii) Subscribed by underwriters as:															
	(a) Investors	6.82	17.24	7.06	5.62	1.91	4.08	2.09	12.54	13.18	0.40	-	0.10	44.82	18.19	-
	(b) An underwriting obligation	7.02	10.58	5.59	19.37	9.78	4.28	6.23	28.50	31.00	17.66	17.59	4.08	18.80	36.64	57.68
	iii) Unsubscribed	0.31	-	0.42	1.39	0.04	0.11	0.19	0.01	4.67	-	-	-	2.64	1.21	-
	III. Amount Underwritten	30.52	54.75	25.20	52.90	33.58	37.61	42.12	261.38	162.70	101.11	144.20	274.13	422.21	129.75	432.25
	III as percentage of II	91.7	97.1	88.3	92.6	72.7	77.8	56.8	86.6	79.2	66.7	74.4	63.8	61.2	41.0	39.9
3.	Index Numbers of Industrial Securities, Ordinary Shares (All Industries) (Base years 1970-71 = 100 and 1980-81 = 100)	100.00	97.3	103.9	107.4	130.4	143.2	100.00	118.9	110.4	125.3	136.0	221.7	230.6	207.3	247.5

Sources : 1) R.B.I. Report on Currency and Finance, 1979-80, Vol. II, pp. 86, 92-96.
 2) R.B.I. Report on Currency and Finance, 1980-81, Vol. II, pp. 84, 90-94.
 3) R.B.I. Report on Currency and Finance, 1986-87, Vol. II, pp. 80, 96-97.
 4) R.B.I. Report on Currency and Finance, 1989-90, Vol. II, pp. 92, 112-113.

preceding base year 1980-81. The index further rose to 136 in 1984-85, to 222 in 1985-86, to 231 in 1986-87 and to 247.5 in 1988-89. This spurt in investment activity during these years after 1980-81, must be the result of tax simplification provisions and investment allowance.

(iii) Impact on Capital Structure: It is argued that corporation tax levy also affects the capital structure - owned capital vis-a-vis borrowed capital. Under the Indian corporation tax, interest payments to debenture-holders are deductible as allowable expenses whereas dividend payments are not. It is, therefore, contended that tax advantage provides an incentive to issue debentures as against equity capital issues. On this ground, critics of the tax argue that increased dependence on debenture issues might increase liability of interest payments on corporations leading to financial stress and reserve depletion during the period of business slackness or depression. Empirical studies in U.S. suggest that the choice between stocks and bonds is not significantly affected by corporate taxation.

Indian evidence shows a tendency towards more debenture financing during the period 1961-65 at the rate of 20 per cent of the total capital issues as against 10 per cent during the preceding five year period 1956-60 (annual averages).¹⁰ This might suggest that deductibility of interest on debentures has encouraged corporations to resort to debenture financing as against financing through equity

capital. Recent trends in capital issues by new and existing companies in India, however, are uncertain and unpredictable. As a matter of fact, a high rate of effective corporation tax ought to have encouraged Indian corporations, existing as well as new, to issue more and more debentures. This has not happened as can be seen from Table 4.6 which shows capital issues by new and existing companies during the period from 1976 to 1980. New companies issued Rs.0.24 crores debentures in 1976-77 (merely 0.6 per cent of the equity capital), just Rs. 2.02 crores in 1978-79 (3 per cent of equity), and Rs. 7.15 crores in 1979-80 (7.4 per cent of equity). Within the period of five years from 1975-76 to 1979-80, existing companies did not issue any debenture capital in the years 1976-77 and 1979-80.

There seems to be a favourable shift towards debenture capital from the year 1980-81 onwards. Debentures sold in 1980-81 amounted to Rs. 63.80 crores while the amount of equity issue was Rs. 71.24 crores. This means debentures were 89.6 per cent of the equity issued during the same year. In the year 1982-83 the relative percentage was 101.6. In the later years i.e. from 1983-84 to 1985-86, debentures as percentage of equity suddenly dropped to 11.5 per cent, 22.3 per cent and 15.7 per cent respectively. In 1986-87, there was again a sudden rise in debenture issues amounting to Rs. 575.5 crores or 78 per cent of the equity issues during the same year. Since interest on debentures is an

allowable expenditure for computation of taxable income, this change in favour of debenture capital issues by the companies in an attempt to reduce their tax liability can be understood.

(iv) Sources of Financing: Corporation tax also influences sources of company financing, internal vis-a-vis external sources. Internal sources, namely, retained profits and depreciation reserves, can be had without any cost to the company. Naturally, companies following conservative policies try to exploit internal sources of financing to a great extent. Indian companies in our sample were largely dependent upon internal sources from 1970-71 to 1972-73; however, from 1973-74 onwards there has been continuous fall in the extent of dependence on internal sources of financing.

Table 4.8 gives distribution of sources of funds in the sample companies during 1970-71 to 1987-88. In 1970-71, the sample companies financed their investment from internal sources to the extent of 50.3 per cent and through external sources to the tune of 49.7 per cent. The relative percentages in 1972-73 were: internal sources 73.4 per cent and external sources 26.6 per cent. Share of internal sources dropped to 51.7 per cent in 1973-74 and gradually dropped upto 28.1 per cent in 1981-82, with a compensatory rise in external sources. Between the period 1982-83 and 1985-86, the tendency again reversed, slightly in favour of internal

Table 4.8 : Distribution of Sources of Funds in the Small and Medium Indian Companies During 1970-71 to 1987-88

	(Rs. Crores)																		
Year	1970-71	1971-72	1972-73	1973-74	1974-75	1975-76	1976-77	1977-78	1978-79	1979-80	1980-81	1981-82	1982-83	1983-84	1984-85	1985-86	1986-87	1987-88	
Number of Companies	1650	1650	1650	1650	1650	1650	1720	1720	1720	1720	1800	1800	1838	1838	1838	1953	1953	1953	
Sources																			
I. Internal																			
a) Retained Profits	109	154	151	229	367	140	130	158	279	472	576	567	499	259	365	721	352	-73	
b) Depreciation	194	339	381	419	525	412	318	413	485	619	664	734	915	1314	1671	1830	1850	2540	
Total	303 (50.3)	493 (61.2)	532 (73.4)	648 (51.7)	992 (48.6)	552 (42.9)	448 (42.1)	571 (41.7)	754 (41.9)	1091 (42.0)	1240 (38.7)	1301 (28.1)	1414 (30.5)	1573 (37.5)	2036 (39.3)	2551 (34.3)	2202 (29.6)	2467 (35.4)	
II. External																			
a) Borrowings	139	129	12	214	447	421	298	352	473	691	925	1732	1884	1698	1700	2866	2983	2413	
b) Equity	18	25	18	18	29	32	39	29	46	47	47	96	75	185	180	177	254	1149	
c) Others	142	159	163	374	572	281	279	417	527	707	989	1496	1267	742	1268	2849	2000	945	
Total	229 (49.7)	313 (38.8)	193 (26.6)	606 (48.3)	1048 (51.4)	734 (57.1)	616 (57.9)	798 (58.3)	1046 (58.9)	1445 (58.0)	1961 (61.3)	3324 (71.9)	3226 (69.5)	2625 (62.5)	3148 (60.7)	4892 (65.7)	5237 (70.4)	4497 (64.6)	
Grand Total (I + II)	602 (100.0)	806 (100.0)	725 (100.0)	1254 (100.0)	2040 (100.0)	1286 (100.0)	1064 (100.0)	1369 (100.0)	1800 (100.0)	2596 (100.0)	3201 (100.0)	4625 (100.0)	4640 (100.0)	4198 (100.0)	5184 (100.0)	7443 (100.0)	7439 (100.0)	6964 (100.0)	

Note : Figures in brackets indicate the per cent to total sources of funds during the corresponding years.

Sources : 1) R.B.I. Bulletin, February 1981, Vol. XXIV, No. 2, pp. 89-115.

2) R.B.I. Reports on Currency and Finance, Vol. II, 1975-76, 1979-80, 1983-84, 1984-85 to 1989-90.

sources. Again, in the succeeding year, 1987-88, external sources contributed 70.4 per cent of capital. However, there seems to be no relationship between the effective tax rate and the sources of financing adopted by the companies. There might be some non-economic factors governing capital structure of companies like investors' choice of securities, etc.

Table 4.9 shows pattern of assets and liabilities of RBI sample companies (small and medium) from various paid-up capital size groups for the period from 1970-71 to 1987-88.

It will be clear from the Table that in the initial stage of a company, the proportion of share capital and borrowings is bound to be higher in total capital because of the absence of internal sources of capital, namely, reserves and surplus and provisions. On the other hand, as the companies grow, the proportion of share capital to the total liabilities goes on diminishing. This proportion varies according to the size of the companies; for example, average percentage of share capital of 1650 small and medium companies during the period from 1970-71 to 1975-76 was 19.6 per cent of the total liabilities. Year to year percentage varied between a low of 16.6 per cent in 1975-76 and a high of 22.3 per cent in 1971-72. Share capital as per cent of total liabilities has been continuously declining since 1977-78 with a corresponding rise in other liabilities like borrowing and trade credits. In case of small and medium

Table 4.9 : Pattern of Assets and Liabilities of Small and Medium Public Limited Non-Government Companies, 1970-71 to 1987-88

	(Rs. Crores)																		
Year	1970-71	1971-72	1972-73	1973-74	1974-75	1975-76	1976-77	1977-78	1978-79	1979-80	1980-81	1981-82	1982-83	1983-84	1984-85	1985-86	1986-87	1987-88	
Number of Companies	1650	1650	1650	1650	1650	1650	1720	1720	1720	1720	1800	1800	1838	1838	1838	1953	1953	1953	
LIABILITIES																			
1. Share Capital	1541 (22.3)	1593 (21.3)	1645 (20.8)	1706 (19.2)	1808 (17.2)	1899 (16.6)	1992 (16.8)	2147 (16.4)	2269 (15.7)	2357 (14.5)	2788 (13.4)	2969 (11.9)	3246 (10.9)	3476 (10.3)	3637 (9.4)	4243 (8.7)	4651 (8.5)	5245 (8.7)	
2. Reserves and Surplus	1140 (16.5)	1272 (17.0)	1415 (17.8)	1615 (18.2)	2011 (18.9)	2100 (18.3)	2077 (17.5)	2234 (17.1)	2484 (17.1)	2868 (17.6)	3544 (17.0)	4214 (16.9)	5119 (17.1)	6113 (18.1)	7809 (20.0)	11232 (23.0)	12234 (22.2)	13311 (22.2)	
3. Provisions	276 (4.0)	335 (4.4)	403 (5.0)	499 (5.6)	664 (6.2)	714 (6.2)	680 (5.7)	692 (5.3)	715 (5.0)	824 (5.0)	977 (4.7)	1014 (4.0)	1085 (3.6)	1163 (3.4)	1332 (3.4)	1483 (2.5)	1362 (2.5)	1372 (2.3)	
4. Borrowings	2621 (37.9)	2775 (37.1)	2799 (35.3)	3022 (34.0)	3446 (32.7)	3883 (33.8)	4180 (35.2)	4576 (35.0)	5052 (35.0)	5670 (34.8)	7479 (35.8)	9211 (36.9)	11465 (38.3)	13180 (39.0)	14922 (38.4)	18556 (38.1)	21703 (39.5)	24210 (40.3)	
5. Trade Dues and Current Liabilities	1332 (19.3)	1503 (20.2)	1665 (21.1)	2048 (23.0)	2603 (24.9)	2883 (25.1)	2960 (24.8)	3415 (26.2)	3940 (27.2)	4590 (28.1)	6075 (29.1)	7553 (30.3)	9011 (30.1)	9865 (29.2)	11196 (28.8)	13232 (27.2)	15031 (27.3)	15952 (26.5)	
Total	6911 (100.0)	7476 (100.0)	7927 (100.0)	8890 (100.0)	10532 (100.0)	11479 (100.0)	11889 (100.0)	13064 (100.0)	14460 (100.0)	16309 (100.0)	20863 (100.0)	24961 (100.0)	29926 (100.0)	33797 (100.0)	38896 (100.0)	48746 (100.0)	54931 (100.0)	60090 (100.0)	
ASSETS																			
1. Net Fixed Assets	2814 (40.7)	2936 (39.3)	3130 (39.5)	3364 (37.8)	3771 (35.9)	4170 (36.3)	4399 (37.0)	4852 (37.4)	5295 (36.6)	5757 (35.3)	7748 (37.1)	9334 (37.5)	11943 (39.9)	14213 (42.0)	16966 (43.6)	22293 (46.0)	24958 (45.4)	27340 (45.5)	
2. Inventories	2199 (31.8)	2500 (33.4)	2645 (33.4)	3051 (34.3)	3923 (37.2)	4099 (35.7)	3974 (33.4)	4296 (32.9)	4901 (33.9)	5768 (35.3)	7009 (33.6)	8349 (33.4)	9180 (30.7)	9394 (27.8)	10198 (26.2)	12206 (25.0)	13323 (24.2)	14171 (23.6)	
3. Loans and Advances and Other Debtor Balance	1376 (19.9)	1497 (20.0)	1579 (19.9)	1773 (19.9)	2094 (19.9)	2422 (21.1)	2684 (22.6)	2960 (22.7)	3257 (22.5)	3695 (22.7)	4717 (22.6)	5736 (22.9)	6949 (23.2)	8011 (23.7)	9116 (23.4)	10814 (22.0)	12482 (22.8)	14276 (23.8)	
4. Investments	175 (2.5)	182 (2.4)	196 (2.5)	206 (2.3)	217 (2.1)	233 (2.0)	233 (2.0)	275 (2.1)	302 (2.1)	322 (2.0)	368 (1.8)	401 (1.6)	451 (1.5)	570 (1.7)	849 (2.2)	1253 (2.6)	1558 (2.8)	1786 (2.9)	
5. Cash and Other Assets	347 (5.02)	361 (4.8)	377 (4.7)	496 (5.6)	527 (4.9)	555 (4.8)	599 (5.0)	651 (4.9)	705 (4.9)	767 (4.7)	1021 (4.9)	1141 (4.6)	1403 (4.7)	1609 (4.8)	1767 (4.6)	2180 (4.4)	2660 (4.8)	2517 (4.2)	
Total	6911 (100.0)	7476 (100.0)	7927 (100.0)	8890 (100.0)	10532 (100.0)	11479 (100.0)	11889 (100.0)	13064 (100.0)	14460 (100.0)	16309 (100.0)	20863 (100.0)	24961 (100.0)	29926 (100.0)	33797 (100.0)	38896 (100.0)	48746 (100.0)	54981 (100.0)	60090 (100.0)	

- Sources: 1) R.B.I. Report on Currency and Finance, Vol. II, 1975-76, p. 76.
 2) R.B.I. Report on Currency and Finance, Vol. II, 1980-81, p. 73.
 3) R.B.I. Report on Currency and Finance, Vol. II, 1986-87, p. 74.
 4) R.B.I. Report on Currency and Finance, Vol. II, 1987-88, p. 78.

companies, reserves and surplus is generally slightly less than share capital while in case of large companies it is the other way round because of the large reserves and surpluses accumulated over past years.

Borrowings as per cent of total liabilities had a gradual rising trend between 1971-72 and 1975-76 in respect of companies under construction. In the year 1971-72, borrowings as per cent of total liability was 45.4 per cent; the ratio increased steadily upto 62.4 per cent in 1975-76 for companies under construction. In fact, such a heavy borrowing would create huge burden on fixed interest liability, perhaps more than the capacity of such companies to withstand. However, lack of good public response to the new equity issues of such companies must have obliged them to rely more on borrowed rather than owners' funds. The tendency is exactly opposite in case of medium and large companies, in whose case borrowing as per cent of total issues gradually declined from 38 per cent to 33 per cent of the total liabilities, between 1971-72 and 1974-75. In case of large companies (426), borrowings constituted around 35 per cent of liabilities for all the three years—1977-78 to 1979-80—for which the data are available. On an average, share capital plus reserves and surplus are more or less equal to borrowings in respect of medium and large scale companies and 426 large companies. In case of companies under construction, borrowings have a tendency to outstrip

ownership capital (share capital + reserves). Again, irrespective of some changes in the rates of corporate income-tax or changes in deductions, allowances, etc., there was no change in the proportion of ownership and borrowed capital. We can thus conclude that the capital structure of Indian corporations over the last decade had been insensitive to the changes in the effective corporation tax rate.

(v) Profitability Trends: The Reserve Bank of India studies of the profitability and other ratios of the sample companies are reproduced in Table 4.10. The following features may be mentioned.

(1) Gross profit as percentage of total net assets.

This ratio was within the range of 7.4 per cent and 12.8 per cent. While the highest ratio was observed in 1974-75 the lowest was recorded in 1987-88. This ratio does not show any relationship with the effective corporation tax-rate.

(2) Gross profit as percentage of sales. This ratio ranged between 7.8 per cent in 1987-88 and 11.4 per cent in 1974-75. However, the ratio was lower during the years in which effective tax rates were higher, say, 1975-76 to 1977-78, 1983-84 to 1987-88.

(3) Profit-after-tax as percentage of net worth. This ratio is directly related to the effective corporation tax rate and, therefore, showed a low level of profits in the years in which effective tax rate was high and highest ratio

Table 4.10 : Profitability and Other Ratios of the Private Corporate Sector: Small and Medium Public Limited Companies, 1970-71 to 1987-88

Year	1970-71	1971-72	1972-73	1973-74	1974-75	1975-76	1976-77	1977-78	1978-79	1979-80	1980-81	1981-82	1982-83	1983-84	1984-85	1985-86	1986-87	1987-88	
Number of Companies	1650	1650	1650	1650	1650	1650	1720	1720	1720	1720	1800	1800	1838	1838	1838	1953	1953	1953	
Profitability Ratio																			
1. Gross Profit as Percentage of Total Net Assets	10.7	10.8	10.5	11.3	12.8	10.4	11.1	11.0	11.7	12.6	11.9	11.1	9.9	8.4	8.6	8.8	8.0	7.4	
2. Gross Profits as Percentage of Sales	10.7	10.3	9.7	10.7	11.4	9.1	9.1	9.0	10.1	9.6	9.7	9.1	8.9	7.9	8.1	9.0	8.5	7.8	
3. Profit After Tax as a Percentage of Net Worth	11.7	10.8	10.4	11.7	13.7	8.2	8.3	8.8	11.5	14.5	14.5	13.0	12.1	6.8	7.1	8.3	5.7	3.5	
Other Ratios																			
4. Debt as Percentage of Equity	43.0	42.0	41.7	41.0	38.7	40.8	46.7	46.2	48.0	51.1	63.4	72.2	84.5	87.7	83.6	110.7	117.4	118.0	
5. Ratio of Current Assets to Current Liabilities	1.29	1.30	1.32	1.33	1.31	1.25	1.25	1.23	1.21	1.23	1.21	1.22	1.22	1.21	1.19	1.21	1.21	1.23	

- Sources :**
- 1) R.B.I. Report on Currency and Finance, Vol. II, 1977-78, p. 67.
 - 2) R.B.I. Report on Currency and Finance, Vol. II, 1983-84, p. 75.
 - 3) R.B.I. Report on Currency and Finance, Vol. II, 1984-85, p. 76.
 - 4) R.B.I. Report on Currency and Finance, Vol. II, 1986-87, p. 74.
 - 5) R.B.I. Report on Currency and Finance, Vol. II, 1987-88, p. 78.
 - 6) R.B.I. Report on Currency and Finance, Vol. II, 1989-90, p. 88.

of 13.7 per cent was registered in 1974-75 and the lowest of 3.5 per cent was registered in 1987-88.

(vi) Impact on Growth of Corporate Sector: In spite of fluctuation in the effective corporation tax rate either due to change in statutory tax rate or due to changes in deductions, allowances and concessions, etc., there had been a sizable growth of corporate sector in India. Companies of all types, government and non-government, public and private limited, small, medium and large, etc., are growing not only in number but also in regard to their paid-up capital. Table 4.11 analyses the growth of different types of companies from 1971 to 1987.

Among the government and non-government companies, growth of public limited non-government companies was by far higher as far as absolute number of companies is concerned. However, growth of paid-up capital of the private limited government companies was higher than that of non-government companies.

If we take into account all types of companies, the number of companies increased by 5 to 6 per cent per annum between 1971 and 1979. The rate of growth in the number of companies after 1980 was rather rapid, ranging between 12 and 24 per cent. During the same period of time, growth in the paid-up capital of all the companies was faster than the growth in the number of companies. Between 1980 and 1987, growth in paid-up capital ranged between 10.2 and 46.5

Table 4.11 : Growth of Companies in India During 1971 to 1987

Year	Government Companies				Non-Government Companies				Total Public & Private Companies				Annual Rate of Growth (Per Cent)							
	Public Ltd.		Private Ltd.		Public Limited		Private Limited		Public Limited		Private Limited		All Companies		Public Ltd.		Private Ltd.		Total (All Companies)	
	No.	Paid-up Capital	No.	Paid-up Capital	No.	Paid-up Capital	No.	Paid-up Capital	No.	Paid-up Capital	No.	Paid-up Capital	No.	Paid-up Capital	No.	Paid-up Capital	No.	Paid-up Capital	No.	Paid-up Capital
1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21
1971	91	143.2	223	1931.3	6599	1948.3	23409	490.9	6690	2091.5	23652	2422.2	30322	4513.7	-	-	-	-	-	-
1972	107	156.0	245	2213.1	6703	2035.9	25212	535.8	6810	2191.9	25457	2748.9	32267	4940.8	2.8	4.8	7.6	13.5	6.4	9.5
1973	126	219.0	264	2779.4	6819	2175.6	27147	574.5	6945	2394.6	27411	3353.9	34356	5748.5	2.0	9.3	7.7	22.0	6.5	16.3
1974	147	249.1	303	4396.0	7071	2323.3	29964	662.6	7213	2575.4	30267	5058.6	37485	7631.0	3.9	7.6	10.4	50.8	6.5	32.7
1975	210	315.4	363	4650.6	7275	2448.4	32736	750.4	7485	2763.8	33099	5401.0	40584	8164.8	3.7	7.3	9.4	6.8	8.3	7.0
1976	243	408.5	408	5653.7	7465	2536.1	35149	783.3	7708	2944.6	35557	6437.0	43265	9381.6	3.0	6.5	7.4	19.2	6.6	14.9
1977	273	591.9	428	6582.6	7585	2554.4	37346	819.3	7858	3146.3	37774	7401.9	45632	10548.2	1.9	6.8	6.2	15.0	5.5	12.4
1978	300	725.5	445	7802.1	7725	2649.4	39485	847.3	8025	3374.9	39930	8649.4	47955	12024.3	2.1	7.3	5.7	6.9	5.1	14.0
1979	321	852.7	461	7462.5	7893	2688.0	42376	874.9	8214	3540.7	42837	8337.4	51051	11878.1	2.4	4.9	7.3	-3.6	6.5	-1.2
1980	353	973.6	472	8779.7	8225	2751.5	46730	906.8	8578	3725.1	47202	9686.5	55780	13411.6	4.4	5.2	10.2	16.2	9.3	12.9
1981	352	1095.9	499	9757.2	8749	2856.2	52401	967.2	9101	3952.1	52900	10724.4	62001	14776.5	6.1	6.1	12.1	10.7	11.2	10.2
1982	374	2183.9	520	11125.4	10169	4083.1	61339	1543.1	10543	6267.0	61859	12688.5	72402	18935.5	15.8	58.6	16.9	18.3	16.8	28.1
1983	411	2827.9	532	13907.5	11371	4642.9	70589	1678.1	11782	7470.8	71121	15585.6	82903	23056.4	11.8	19.2	15.0	22.8	14.5	21.8
1984	427	3315.6	546	16195.0	12523	5114.4	80768	1875.4	12950	8430.0	81314	18070.4	94264	26500.4	9.9	12.8	14.3	15.9	13.7	14.9
1985	419	4247.7	561	18199.3	14149	5640.8	92240	1998.6	14568	9888.5	92801	20197.9	107369	30086.4	12.5	17.3	13.4	11.8	13.9	13.5
1986	443	5356.0	577	21731.8	15682	6420.1	105457	2175.8	16125	11776.1	106034	23907.6	122159	35683.7	10.7	19.1	14.3	18.4	13.8	18.6
1987	469	8522.5	597	25270.4	18260	15711.0	132360	2790.3	18729	24233.5	132957	28060.7	151686	52284.2	16.1	105.8	25.4	17.4	24.2	46.52

Sources : 1) Survey of Public Enterprises, 1984-85, Vol. I. Bureau of Public Enterprises, Ministry of Industry, New Delhi.
2) Annual Report on the Working and Administration of the Companies Act, 1956, March 1985.

per cent. Though it is argued that burden of corporation tax adversely affects the growth of corporate sector in our country, the evidence does not support this argument. On the contrary, the growth in number and size of capital since 1971 onwards proves that corporation tax has not at least adversely affected their growth.

Notes and References

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5. Ambirajan, S., op.cit., pp. 220-238.
6. Gandhi, Ved P., op.cit., p. 75.
7. Palkhivala, N.A. The Highest Taxed Nation. Manaktalas, Bombay, 1965, pp. 34-35.
8. This drop might have been a result of the passing of the Companies (Temporary Restrictions on Dividends) Ordinance, 1974.
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CHAPTER 5

SUMMARY, FINDINGS AND SUGGESTIONS

5.1 Summary

There is a general consensus in the ^{private} sector and among a number of economists that Indian corporations are the highest taxed corporations in the world. In a country of the Third World like ours, where rapid industrialization and shifting of surplus manpower to secondary and tertiary sectors is the need of the hour, it is desirable to lessen the burden of heavy taxation on corporate income.

In India, corporations are subject to company tax at a flat rate under the Indian Income Tax legislation. The rates of company taxes are discriminatory in character; foreign companies are discriminated against by way of higher tax rate with an object of encouraging growth of domestic companies. Among domestic companies, closely-held companies are charged corporation tax at a higher rate than the widely-held companies with an object of discouraging concentration of economic power in the hands of a few. Discrimination is also made on the basis of purpose viz., income of foreign companies from manufacturing and trading activity and income by way of fees and royalties are charged at different rates. Domestic companies running priority industries receive tax

concessions as compared to those working in non-priority industries.

Though the statutory tax rate for different types of companies are fairly stable over past many years, there are frequent changes in the allowable deductions, allowable business expenses and entertainment expenses, tax concessions for specified industries, Investment allowance, development rebate, etc., from time to time through finance bills. Such changes do affect the tax base and effective corporation tax rate. A change in effective tax rate may affect private sector's savings, investment, profits after tax and capital structure of the companies.

This study of Corporate Taxation in India for the period 1970-71 to 1989-90 is undertaken with a view to examine the validity of the argument that Indian corporations are under excessive burden of tax on their income. It is also intended to find out effective corporation tax rate for different types of Indian and foreign companies, revenue and income elasticities of corporation tax in India, and impact of Corporation Income Tax in India on savings, investment and capital structure of Indian companies.

In Chapter 1, we have discussed the concept of corporation and corporate personality as regards responses to change in taxes on income. Because of divergence of

ownership and control in corporations, shareholders are least interested and involved in the management and control of day-to-day business affairs. Interest of the shareholders is limited to their investment in shares, dividend income, and capital appreciation. So long as they receive a fair dividend they do not care about the effective rate of corporation tax. This is, perhaps, the reason why changes in the effective rate of corporation tax due to changes in deductions, allowances, concessions and allowable expenses, etc., are not resisted upon by the owners of corporations. In this respect, the responses to corporation tax are more like an indirect tax, though it is, by definition, a direct tax. In the later chapters of this work, we have examined reactions of the corporations to change in effective corporation tax rate through changes in private corporate saving, investment and capital structure, keeping in view the impersonal corporate management.

We have taken a historical review of company taxation in India prior to passing of Indian Income Tax Act, 1961 in Chapter 2 and also discussed at length the present rate structure of Corporate Income Tax in India. Implications of super tax on company's profits and the levy of surcharge on income tax have also been discussed in order to find out statutory corporation tax rate for different types of companies. The issue whether Indian corporations are highest taxed in the world and the economic base of the tax are also discussed in this chapter.

Some of the important deductions and allowances which can be enjoyed by the companies in India are discussed in Chapter 3. Such deductions include (i) expenses, depreciation, donations to charitable institutions and to scientific research, inter-corporate dividends, etc. (ii) Allowances include development allowance, rural development allowance, agricultural development allowance and export market development allowance. Changes in provisions regarding deductions and allowances that have been introduced through various Finance Acts upto 1988-89 and the impact of such changes on effective tax rate have been considered. Tax-holiday for priority industries in their initial stage and its utility has also been discussed.

Chapter 4 reviews the concept of effective corporation tax rate, revenue and income elasticity of corporation tax in India during the period 1970-71 to 1989-90 by using RBI data, the All India Income-Tax Statistics published by the Directorate of Inspection (Research, Statistics and Publication), New Delhi.

This chapter being the core of the work, a detailed discussion has been provided on incidence of corporation income tax, on whom the incidence of the tax would ultimately rest and its impact on saving, investment, capital structure, profitability and on the growth of corporate sector itself.

5.2 Findings

(1) Corporate Personality: The distinctive character of corporate personality i.e. divergence between ownership and control in corporations has turned the influence of corporation tax like an indirect tax. Shareholders, i.e. the owners of corporations, show little or no resistance to any rise in effective tax rate.

(2) Tax Rate: Corporation tax rate for different types of companies have been fairly stable since passing of Income Tax Act, 1961, except levy and changes in the rate of surcharge on corporation tax. Differential tax treatment for domestic and foreign companies and among domestic companies between widely-held and closely-held companies can be justified on the grounds of incentives for growth of domestic companies and social justice. Statutory rates of corporation tax in India are highest in the world. A further upward revision of this tax may lead to disincentives for investment at home. Thus, the available evidence lends support to the first hypothesis. A downward revision of corporation Income Tax is necessary.

The complaint that corporation tax structure in our country is very much complicated with a number of conditional deductions and allowances, seems to be true. The whole system is difficult to understand except for financial and taxation experts. The need for simplification of tax structure has been voiced for long.

(3) Effective Tax Rate: The task of arriving at an effective corporation tax rate is very difficult in our country, though by definition, its computation appears to be simple. In order to arrive at correct effective tax rate, we must have accurate information about profits before tax, statutory tax rate (inclusive of surcharges, if any), allowable deductions and allowances available to the particular class of the company, refunds, if any, out of gross tax paid, etc. Systematic information on these items is hardly available by categories of companies. Hence, what we mean by 'effective tax rate' in India is just an average rate of corporation tax for all types of companies together. As such, it is difficult to assess the impact of a change in surcharge rate or rates of deduction and allowances on a particular company or class of companies.

(4) Incidence of Corporation Income Tax : After discussing the views of scholars in the field as to who bears ultimate burden of corporation tax, it is concluded that since corporation tax is a direct tax, its forward shifting is difficult. However, under the conditions of rising money income when consumer demand increases due to extra purchasing power in the hands of people, the tax can be shifted forward through increased prices. On the other hand, when there are inflationary pressures on the economy, the corporations may face consumers' resistance to price rise. Reduced demand for corporate output would result in

backward shifting of the tax. When forward or backward shifting becomes impossible corporations themselves shall bear the tax burden through reduced retained earnings. Tax can also be shifted to shareholders by way of reducing the rate of dividend. It is observed during the period under review that corporation tax was shifted to shareholders during the years 1972-73 to 1974-75, 1977-78 to 1979-80 and 1983-84 to 1985-86. Companies themselves had borne the tax burden between 1974-75 and 1976-77, 1982-83 to 1983-84 and 1985-86 to 1987-88. During the remaining years, the tax is presumably shifted either forward or backward for which further investigation is necessary.

(5) Impact of Corporation Tax: Impact of corporation tax on private corporate savings, investment, capital structure, profitability trends of corporations were examined. The main findings on these aspects are summarized below.

(1) Impact on Savings: A heavy effective corporation tax leads to reduction in the retained earnings or savings of the corporations. A study of RBI sample companies for the period from 1970-71 to 1987-88 reveals that there is a perfectly negative relationship between effective tax rate and retained earnings of companies. Retained earnings fell during the years 1970-71 to 1972-73, 1974-75 to 1976-77, 1982-83 to 1983-84 and from 1985-86 to 1987-88, when effective tax rate was showing an increase.

Domestic private corporate sector savings in absolute

terms as well as in terms of per cent of NNP at current market prices and as a per cent of total domestic net savings decreased when total domestic net savings also decreased when effective tax rate is high. This was noticed for the years 1975-76 and 1976-77, 1983-84 and again in 1986-87 and 1987-88. Corporate savings were marginally negative in 1987-88, when effective corporation tax rate reached a new height of 54.8 per cent. Heavy corporation tax rates do affect the level of private corporate savings.

(ii) Impact on Investment: We have examined the impact of corporation tax on the investment of private sector alone because public sector investment is not necessarily guided by profit motive, an impact of corporation tax on such investment might be negligible.

Investment in fixed assets includes plant and machinery and buildings, etc. Though there are many non-tax considerations governing investment in private sector, like upswing in the business activity, expectations about future profitability and so on, the effective corporation tax rate also leaves some impact on private sector investment. Our analysis shows sudden drop in changes in net fixed assets in 1975-76, 1981-82, 1983-84, 1986-87 and 1987-88. These were the years, incidentally of high effective tax rates, associated with high dividend payment by the companies.

(iii) Impact on Capital Structure: Smith, D.T. argued that corporation tax levy also affects the capital structure of corporations - owned capital vis-a-vis borrowed capital. Our study of capital structure for the period 1970-71 to 1987-88 for the sample companies of the RBI does not provide support for the argument. No doubt, there are changes in the capital structure of corporations, but there appears to be a secular trend since 1973-74 in favour of external sources of funds with slight year-to-year variations. This tendency, however, shows no correlation with the effective tax rate. We may thus conclude that corporation tax may have insignificant impact on capital structure of corporations.

(iv) Profitability Trends: As a corollary, a high rate of a tax on income should reduce the volume and rate of profit. We have used three indicators to measure the profitability of RBI sample (small and medium) companies: (1) Gross profit as percentage of total net assets, (2) Gross profit as percentage of sales, and (3) PAT (Profit-after-tax) as a percentage of Net Worth. All the three indicators do not move exactly in the same direction. A look at this indicator shows that the ratio was low in 1974-75 to 1977-78, 1983-84 and 1986-87 to 1987-88, when effective tax rate was substantially high. On the contrary, the ratio has slightly improved between 1984-85 and 1985-86 when ETR had declined. We can thus establish direct and negative relationship between corporation tax rate and profitability of corporations.

(v) Impact on Growth of Corporations: In spite of changes in the effective tax rate from time to time, the number and size of business corporations in our country have continuously increased. The growth of non-government public limited and private limited companies over the period from 1971 to 1987 is rather smooth. We cannot relate their growth to tax factor. As such there is zero correlation between growth of companies and corporation tax.

Thus our second hypothesis that corporation tax in India adversely affects profit after tax (PAT), savings and investment appears to be true but we could not find any relationship of corporation tax with capital structure, and growth of corporations.

(6) Our findings about discriminatory tax treatment for domestic and foreign companies and among domestic widely-held and closely-held companies give interesting results quite contradictory to our hypothesis number three. We find that throughout the period from 1975-76 to 1988-89 for which comparative data for small and medium and large companies subjected to lower tax rate than small and medium companies. All India Income Tax Statistics for the period from 1974-75 to 1981-82 suggests that though, on an average, closely-held domestic companies pay higher effective tax rate than those of widely-held companies in all the years examined, closely-held companies were charged a higher effective tax rate than foreign companies during the years 1979-80 to 1981-82. This

information suggests that widely-held and closely-held domestic companies paid slightly higher effective tax rate than the statutory tax rate, whereas the effective tax rate for foreign companies was less than the statutory rate fixed for them. Of course, there are constraints about non-availability of comparable data for working out correct effective tax rates. But the available information is enough to conclude that our hypothesis that large companies pay higher tax rate than small ones and domestic companies pay a lower tax rate than foreign companies cannot be proved.

5.3 Suggestions

On the basis of findings of this study we can make the following suggestions.

(1) There is scope for downward revision of effective corporation tax rate. No domestic company be required to pay more than 50 per cent of its profits before tax. Foreign companies and foreign collaborations, on the other hand, should not pay less than 65 per cent of their profits before tax.

(2) Discriminatory tax treatment for small and medium companies and large companies and domestic widely-held and closely-held companies be continued but the difference in the tax rate be widened in favour of small companies and widely-held companies.

(3) The existing system of deductions and allowances

needs simplification. All the deductions available to an individual from different sources of income need not be extended to business corporations. All deductions excluding standard business expenses and investments in approved securities can be denied to business corporations and a lower statutory corporation tax rate be charged. This will not only simplify the tax structure but shall also add to the revenue as it may help reduction in tax evasion.

(4) Instead of a number of allowances for various purposes, the statutory tax rates for the companies involved in priority sectors, new and risky ventures and in foreign trade be fixed at lower rate than for other companies.

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