CHAPTER - II

CORPORATION TAX - II

ON CLOSELY HELD COMPANIES

Private companies and closely held public companies create some special problems of their own. In India, these companies are familiarly known as "companies in which the public are not substantially interested" or "Section 104 companies".[1] They are, hereafter, referred to as closely held companies or close corporations or close companies.

Privileges of incorporation

A closely held company, like any large public company, has life of its own and enjoys perpetual succession. Unlike a partner of a firm, the shareholder is liable to the debts of the company only to the extent of the face value of the shares held by him. His personal properties are not liable to the debts incurred by the company, if the shares held by him are fully paid up. One can without much hesitation become a shareholder of a closely-held company, whether public or private, but, before becoming a partner of a firm, he has to have complete knowledge

---

1. Under the 1922 Act, they were referred to as Section 23A companies.

of the economic conditions and moral worthiness of all the partners of the firm. Naturally, a closely held company commands more resources than a firm and grows in size, and enjoys economics of large scale operation.

From the tax point of view, 'separation of ownership and control' mainly distinguishes closely held companies from a typical large public company. Though in a large scale operation the professionalisation of management cannot be completely avoided, it can hardly be said that, in the majority of closely held companies, the ownership is separated from 'the control'. They are more personal in character. The shareholders often take personal services in the company and the affairs of the company are within their immediate control.

The ownership of the private companies does not often change and it cannot easily be changed, as the private companies are prohibited from having access to the national capital market and from inviting the public to subscribe for any share in or debenture of the company and their shares are not freely transferrable.

Although a private company can have, to the maximum,

50 shareholders, usually shares of the private companies are held by a few persons. Out of the 3,005 private companies for which data are presented by the Taxation Enquiry Commission, in as many as 2,726 companies (97 per cent) 50 per cent or more of the shares are held by 5 or fewer persons, in 2,589 (86 per cent) companies, the majority of shares are owned by 4 or lower persons and in 944 (31.4 per cent) companies the majority of shares are held by only one person.[1]

All things considered, when compared to a widely held public company, a private company or a closely held public company does not benefit much from incorporation. In substance, a closely held company resembles more a partnership firm than a large public company. Naturally, the question arises, is it justifiable to treat a closely held company for taxation purposes as any other typical large public company? Why should it not be taxed in the same manner as a partnership is taxed?.

Taxation of Undistributed Profits

Partnership method

The property of a closely held company, in toto

---

1. Vol. II, p. 176.

belongs to the shareholders. They are, in fact, their personal property which can be disposed of in any manner as and when they wish to do so. The shareholders of such a company are usually rich so as to attract higher bracket rates. Taxation of undistributed profits, therefore, assumes a greater importance in the case of a closely held company.

The partnership method of taxing retained profits, as already noted in an earlier chapter, becomes impracticable in the case of widely held public companies, mainly because that (1) the shares are widely distributed amongst numerous individuals and other institutional investors having different levels of income and attracting varying rates of tax; (2) the shares are freely transferred and (3) usually the shareholders have little interest in the undistributed profits except to the extent they reflect in prices of shares. The shares and the shareholders of a closely held company are free from these characteristics and the partnership method may, therefore, be easily adopted.

The partnership method when applied to closely held companies would not however, be completely free from administrative difficulties. The major difficulty would arise in

defining the companies to which it was to be applied. Private companies alone cannot be said to be closely held. There are public companies which resemble private companies in most essential economic aspects. Of course, we have defined companies in which the public are not substantially interested for the purpose of imposing penal tax for unreasonable accumulation of profits. But if the same definition was adopted for the partnership method, there would arise some anomalies and many legitimate complaints. Present definition of a company in which the public are not substantially interested is designed to check avoidance of tax. This cannot reasonably be adopted for imposing tax itself, and any other definition would create further arbitrary division of business organisations.

Further, the question of adopting the partnership method for taxing companies seems to be essentially a question of economic expediency rather than that of equity. Company form of organisation may be preferred to a partnership as the former is a more stable and perpetual entity and in any case, taxation should not be such as to discourage formation of companies, private or public.

If the partnership method was made compulsory for taxing closely held companies, the private corporate sector would be adversely affected under the present high level of personal taxation. In India, as already noted, closely held companies are under the ownership and control of wealthy shareholders and firms are often incorporated mainly to enjoy the privilege of keeping part of the profits of the business taxed at a flat rate much below the maximum marginal rates applicable to individuals. Taxation of corporate income, retained as well as distributed, at rates applicable to individuals would deny this very privilege of incorporation and would leave hardly any scope for a healthy industrial growth in the country. Further, the compulsory partnership method would show no difference between a growing and a static company. The shareholders of fast expanding companies which require large retention of profits would be much affected and wealthy persons would hesitate to have even minority holdings in such companies.

There are, therefore, compelling reasons for supporting a partnership method which is optional on the part of the companies. In the U.S.A. the Congress authorised (in 1958) companies having no more than 10 shareholders to elect the

partnership basis of taxation, if all the shareholders wish. Under this provision, once an election has been terminated or revoked, the company is ineligible to make another election for five years, unless the Treasury consents.[1] Conversely, a partnership (and also a sole proprietorship) is permitted to elect to be taxed as a company (i) if it is owned by not more than 50 members and (ii) if it is engaged in an enterprise in which capital is a material income producing factor or 50 per cent or more of gross income is derived from trading as a principal or acting as a broker in sales of real property, commodities, or securities.[2]

The usefulness or otherwise of an optional partnership method depends upon many factors, such as, the level of corporate tax, the status and income of the shareholders and the rates of tax applicable to their personal income. They are subject to variations from year to year and in the same year, some shareholders may be affected, the others being benefitted under the scheme. So the administrative considerations require many conditions to the scheme. Some of them are (1) that the numberof share-

---

1. Boris I. Bittker, Federal Income, Estate and Gift Taxation,p.740.

2. Ibid, p. 612. Though the latter provision has proved to be of limited interest, the former has been extensively utilised i.e., almost 8% of all companies which filed returns in 1960-61.

holders should be very limited; (ii) that all of them should consent to the option and (iii) that the option once exercised should not be changed atleast for a few years. The scope of the scheme is thus bound to be limited and arbitrary and even then the success of the scheme is highly doubtful.

The financial conditions of the shareholders of closely held companies, the levels of corporate and personal taxes, the economic policy and the standard of tax administration in the U.S.A. may justify such a radical innovation there. But in India, it does not seem to be reasonable to affect the legal position of business concerns for taxation purposes and as a matter of fact, no one in India has raised seriously the question of taxing closely held companies as partnerships.

Firm Tax

In 1956, however, some tax was, for the first time, imposed on registered firms, and it was explained that the tax was intended to neutralise, to some extent, the advantages of a registered firm as against a company.[1] The scheme of allowing

---

1. Finance Minister's speech, 1956.

(For the assessment year 1966-67)

(Amount in Rs.)

Name of the co. or firm	Income of the co. or the firm	Personal income of the share-holder or part-ner	SHAREHOLDER: Share income from the Co.	Total income 3+4	Tax by the Co. (share)	Tax by the share-holder	Total Tax 6+7	PARTNER: Income from the firm	Total income 3+9	Tax by the firm -rebate	Tax by the partner	Total tax 11+12
1	2	3	4	5	6	7	8	9	10	11	12	13
		Nil	2,400	2,400	6,000	Nil	6,000	10,000	10,000	394	561	955
A*	50,000	10,000	2,400	12,400	6,000	987	6,987	10,000	20,000	348	2,442	2,790
		25,000	2,400	27,400	6,000	4,886	10,886	10,000	35,000	295	8,897	9,192
		50,000	2,400	52,400	6,000	18,651	24,651	10,000	60,000	239	23,826	24,065
		10,000	4,800	14,800	12,000	1,363	13,363	20,000	30,000	1,422	6,138	7,560
B@	1,00,000	25,000	4,800	29,800	12,000	6,038	18,038	20,000	45,000	992	14,256	15,248
		50,000	4,800	54,800	12,000	20,077	32,077	20,000	70,000	804	31,251	32,055
		10,000	12,000	22,000	20,000	2,845	22,845	50,000	60,000	3,740	23,826	27,566
C@	2,50,000	25,000	12,000	37,000	20,000	10,118	30,118	50,000	75,000	3,440	33,413	36,853
		50,000	12,000	62,000	20,000	25,311	45,311	50,000	1,00,000	2,936	52,667	55,603

* Calculations are made only in respect of four partners or shareholders.
@ " " " " three " "

Notes: 1. The company (private) or the firm has 5 equal shareholders or partners. 2. It is assumed that the company pays 60% as tax and out of what remains 60% is declared as dividend. 3. In calculating personal tax deduction is made for annuity deposit. 4. Income of the firm or the company is derived from business. 5. Income in the hands of shareholders or partners is treated as unearned income.

rebates to the partners (Sec. 86) and also the difference made in 1962 between firms in terms of number of partners, go to confirm this explanation. Table 15, when viewed with the available statistics as to the total income of registered firms assessed in recent years, supports this explanation and justifies the firm tax.

It may be clear from the Table that, even if the firm-tax is taken into account, the total amount of tax payable by the partners is less than that payable by the shareholders, provided that in either case the personal income does not exceed Rs. 25,000, and if it exceeds Rs. 25,000, the total income of the concern is about Rs. 1,00,000. In other words, there is a case for the firm tax so long as the personal income of partners is low and the total income of the firm is not very high. The Income Tax Statistics show that almost all registered firms assessed in recent years are small in size. Out of the total number of registered firms assessed in recent years, more than 95 per cent of the firms had the total income of Rs. 2,00,000 or less. Statistics as to the total income of partners are not available. But this may not alter or affect much the above conclusion.

For a wealthy partner of a big firm, incorporation

is beneficial and the extent of the benefit is increased by the firm-tax. The firm tax is, however, negligible and it alone cannot have much influence on the decision of an enterpreneur to conduct business as a partnership. It seems to be an excuse to collect some tax rather than a scheme mainly designed to neutralise the advantage of a registered firm as against a company. Further, equity considerations favour a reverse treatment which reduces the disadvantages of a company as against a firm.

<u>Unreasonable Accumulation of profits</u>

In the absence of complete integration of corporate and personal taxation, a company, public or private, closely held or not, can be allowed to retain only such portion of its profits as is reasonably required for the maintenance and development of the business. The excess over and above that portion of the profits should be distributed and taxed in the hands of its shareholders at rates applicable to their personal income. Retention of profits by the company, in excess of that portion is 'unreasonable' and often results in tax avoidance on the part of the shareholders.

Though the above argument is equally applicable to

all private and public companies, in the case of widely held public companies the problem is only of minor importance which may be overlooked. As the shareholders of a large public company cannot claim its accumulated profits as their personal property, they would, in normal, fight for their rights and try to obtain as dividends their aliquot shares of the profits of the company. Even if the company retains more profits than is required for the maintenance etc. of the business, it can hardly be said that it retains more profits to enable its shareholders to avoid tax, and in fact we encourage public companies to plough back greater and greater portion of their profits rather than to distribute them as dividends.

In the case of a closely held company, on the other hand, the profits, whether distributed or not, are, in fact, the property of its shareholders. They can, without incurring any loss, regulate the distribution of the profits of the company in such a way as to reduce or avoid their personal tax liability. To check this kind of manipulation, some special provisions exist in almost all advanced countries.

Purpose of 'Unreasonable accumulation'.

As already noted, a closely held company may improperly accumulate profits to enable its shareholders either to avoid or to postpone their tax liability. The temptation to manipulate distribution would be more under the new scheme of company taxation where the company pays no tax on retained profits on beh lf of the shareholders. It is well-nigh impossible to state all the ways and means by which the shareholders may avoid their personal tax liability. The following may, however, be taken as more popular devices.

1. Firstly, the shareholders may reduce their liability to higher personal rates of tax by postponing or reducing distribution of the company's profits. Under highly progressive rates of taxes this tendency would be greater. This device can be more effectively carried out where the income of the business and the personal income of the shareholders are subject to wide fluctuations from year to year. Where the personal income is almost stable, they can only postpone their tax liability, that too, at a cost of incurring an additional liability later, in the form of additional personal taxes that become payable on any further distribution of reserves.

2. Secondly, the shareholders may accumulate profits with the view to realise them as capital gains, usually taxable at a reduced rate of tax. This device is subject to severe limitations in India as at present the short-term capital gains are subject to normal rates of tax and 35 per cent of the long-term gains are taxed as ordinary income. This tax burden will be increased considerably if the accumulated profits do not enhance proportionately the share price in the market. In the case of private companies the scope for realising profits as capital gains is very remote as the shares are not freely transferable and as any distribution made out of accumulated profits at the time of liquidation of the company is taxable as dividends.

3. Thirdly, the company may unreasonably retain profits so that the shareholders can receive them in guise of payments not taxable in their hands. Thus the retained profits which are not fully taxed may be used as a fund to finance their consumption and other expenditures.

Some of the devices of this kind are usually barred by extending the meaning 'dividend' under the Income Tax Act.

Under Sec. 2 (22) of the Indian Income Tax Act, 1961,

any distribution to the shareholders by a company, during its life, or on the reduction of capital or on its liquidation is deemed to be dividend to the extent to which the company has accumulated profits. Similarly, debentures, debenture-stock or deposit certificates in any form received by the share-holders are taxed as dividends.

To prevent shareholders of a closely held company from receiving retained profits in the form of advance or loan a special provision was inserted in 1955 on the recommendation of the Taxation Enquiry Commission.[1] According to this provision any payment made by a closely held company by way of advance or loan to a shareholder who has a substantial interest in the company or any payment made on behalf or for the individual benefit of any such shareholder is treated (subject to some exemptions) as dividend in his hands, to the extent to which the company has accumulated profits. Before 1961, loans etc. made to any shareholder, whether he was substantially interested in the company or not, were treated as dividends. As a person who is the beneficial owner of shares (not being shares entitled to a fixed rate of dividend) carrying 20 per cent or more of the voting power in a

---

1. Vol. II, p.165.

company is considered a person having a substantial interest in the company, the change may not leave much scope for avoidance. However, it requires careful scrutiny.

From 1961, bonus - shares whether equity or preference- received by a preference shareholder have been taxed as dividends. Bonus shares received by an equity shareholder are on the other hand, taxable only as capital gains when they are realised. This leaves a loophole, especially for the shareholders of closely held companies, to realise retained profits as long-term capital gains.[1]

4. It may be clear from the above discussion that there is only a very limited scope for the shareholders in India to receive the profits improperly accumulated and not utilised in the business, in guise of income not taxable or as income taxable at a lower rate of tax in their hands. Then if they unreasonably retain profits in the company, the main aim should be to invest the profits so retained in properties unrelated to the normal business activities of the company. Rich shareholders, after all, are going to utilise part of their income for investment purposes, and if they invest the income in the name of the company they

---

1. In a later chapter, taxation of bonus shares is dealt with in detail.

can avoid personal tax on that income. Where the maximum marginal rate on personal income is, say, 80 per cent, a wealthy shareholder who can invest Rs. 20 in his name, is able to invest Rs. 100 in the name of the company. The following simple illustration may make this point clear.

X and Co. is a private company in which Mr. X owns almost all the shares. The total income of the company after tax for the assessment year 1966-67 is Rs. 1,00,000. Reasonable needs of the business are Rs. 60,000. Profits, therefore, to be distributed are Rs. 40,000.

Mr. X's (unearned) income from other sources is Rs. 25,000. He requires about Rs. 19,000 for personal and household expenses.

I. Tax burden if Rs. 40,000 is distributed as dividends:

Total income of Mr. X:	
Dividend from the company	40,000
From other sources	25,000
Total income .. Rs.	65,000
Annuity deposit	6,500
	58,500

	B.F. Rs.	58,500
Income Tax (which comes to 42.4 per cent of Rs. 65,000).		27,539
Income after tax	..	30,961
Household expenses etc.		19,161
Balance	.. Rs.	11,800

Mr. X invests this Rs. 11,800 in a small public company, Y and Co. whose paid up capital consists of 750 equity shares of Rs. 100 each. If at the end of the accounting year relevant to the assessment year 1967-68, Y and Co. declares 7 per cent dividends, Mr. X will receive Rs. 826 which will be taxed at rates applicable to his personal income.

II. Tax burden if Rs. 40,000 is not distributed as dividends

Total income of Mr. X:		Rs.
From other sources		25,000
Annuity Deposit		1,880
	Rs.	23,120
Income tax (which comes to 15.8 per cent of Rs. 25,000).		3,942
Income after tax	...	19,178
Household expenses etc.	...	19,178
Balance ...	Rs.	NIL

Mr. X can invest Rs. 40,000 in the name of X and Co. If he invests this Rs. 40,000 in the shares of Y and Co. at the end of the year the company X and Co. will receive Rs. 2,800 as dividends. If the intercorporate dividend is taxable at 25 per cent, Mr. X will, if at all he likes, receive Rs. 2,100 as net dividend (as against Rs. 826 receivable in - situation I above).

Thus under situation II as against under situation I:

(i) the average rate of tax applicable to Mr. X's income from sources other than the business is reduced from 42.4 per cent to 15.8 per cent.

(ii) Mr. X is able to invest Rs. 40,000 as against Rs. 11,800 and to receive Rs. 2,100 as against Rs. 826 receivable in situation I. The extent of the benefit under situation II will increase with the increase in personal income, the distributable profits of the company, and the rates of personal tax and with the reduction in the rates of tax on intercorporate dividends.

(iii) It may also be noted that in situation II Mr. X is able to exercise control over Y and Co. holding 400 (as against 118) out of 750 shares.

Mr. X may indirectly hold the shares of Y and Co. till A and Co. is finally liquidated or he may receive the income (Rs. 40,000) invested in Y and Co. through A and Co. when his income from other sources falls, thus avoiding application of higher marginal rates of tax. In any case, Mr. X cannot realise this Rs. 40,000 as capital gains even if he sells the company X nd Co. as in India, the capital gains are taxable in the hands of companies and the dividends declared out of capital gains are taxable in the hands of shareholders as normal income, even if they are declared on liquidation of the company.

The undistributed profits of a company may be utilised to maintain and expand the existing business or to start a new business which may be allied to or entirely unconnected with the existing business or to invest in securities or in other properties unrelated to the normal business activities of the company. They may be invested in shares of other companies for the purpose of controlling competition and may even find their way into the call-loan market.[1] Only profits devoted to maintain and expand the existing business can be considered to be profits 'properly'

---

1. James G. Smith, "Economic Significance of the Undistributed Profit Tax", American Economic Review, Vol. 28, (1938), p.737.

or 'reasonably' retained. The remainder, if any, should be subjected to the personal tax liability of the shareholders, before it is invested or consumed.

So, more attention is often given under income tax Acts, to companies requiring no or lesser proportion of their profits for maintenance and legitimate expansion, such as investment and trading companies, and discrimination is made against intercorporate income of closely held companies. In Sweden, for example, closely held companies which fail to make reasonable dividend distribution are denied the inter corporate dividend exemption ordinarily available to other companies.

Allowing a closely held company to unreasonably accumulate profits would result not only in revenue loss to the Government, but also in severe discrimination against all assessees in general, widely held public companies and partnerships, in particular. It would enable rich shareholders to keep the rates of tax applicable to their personal income within a certain limit and would, what is more important, lead to economic concentration, specially of untaxed wealth.

The intensity of the problem is increased by the facts (1) that the intercorporate dividends are taxed at a lesser

rate of tax and (ii) that the Indian Companies Act does not limit the power of a private company (which is not a subsidiary of a public company) to have minority or majority shareholding in other public or private companies and to have control over them.[1] It is, on the other hand, reduced by (i) the existing extensive definition of 'dividend' under the Income Tax Act, (ii) taxation of capital gains and (iii) by the Wealth Tax, the Estate Duty and the Gift Tax. The definition of dividend and the capital gains tax prevent shareholders from receiving retained profits of the company as non-taxable income, and the other taxes impose a higher amount of tax on the accumulated profits than what would have been payable had there been no improper accumulation. None of them, however, prevents a company to improperly accumulate profits. A special set of provision, therefore, becomes imperative for this purpose, and sections 107 to 109 of the Indian Income Tax Act, 1961 are designed for this purpose.

Indian Provisions: (Secs. 104-109)

These provisions were enacted in 1930 following those in the U.K. Since then they have been amended almost every

---

1. Sec. 372.

year and in fact they are the much amended provisions in the Indian Income Tax Act. Two important steps in their history, however, took place in 1939 and 1955 consequent on the recommendations of the Income Tax Enquiry Committee of 1936 and the Taxation Enquiry Commission of 1953-54, respectively. In 1964 closely held companies were, for the first time, asked to pay a higher rate of tax and this may be considered as the third one. These provisions, as now stand, are discussed below and a brief history of them is given wherever necessary.

In short, these provisions require every (non-industrial) company in which the public are not substantially interested to distribute a certain prescribed percentage (statutory percentage) of its profits after tax as dividends. If it fails to do so, the I.T.O. is empowered under section 104, to impose an additional penal tax on the entire undistributed balance. This is subject to some minor exemptions and concessions.

Roughly, a company in which the public are not substantially interested may be defined as (i) a private company or (ii) a public company if its shares carrying 51 per cent or more of the voting power are beneficially held (a) by the directors and/or section 104 companies and their nominees or (b) by five or

less persons, whether directors or not, and their nominees and relatives (Sec. 2 (18)).

The above conditions are linked with '5 or less persons' perhaps following the U.K. provision. The data presented by the Taxation Enquiry Commission in respect of 3005 private companies in India, however, show its reasonableness. Out of those 3005 private companies in as many as 2726 companies (97 per cent of the total) majority of shares are held by 5 persons or less.[1]

All private companies are companies in which the public are not substantially interested and it is not known how many public companies are covered by the above definition. At present there are 20385 private companies with paid-up capital of Rs. 304 crores. The definition thus covers not less than 76 per cent of total companies at work, commanding 18 per cent of total paid-up capital. For the assessment year 1962-63, nearly 77 per cent of total number of companies assessed were private companies and out of total tax demand more than 45 per cent was made on private companies.

---

1. Vol. II, p. 176.

Satutory Percentage

In the U.K. and the U.S.A. a company is penalised when it retains more than 'unreasonable' part of the profits having regard to the current requirements of the company's business and also to such other requirements as may be necessary or advisable for the maintenance and development of the business. In India also, before 1939, one of the conditions for penalising the company was that it accumulated profits beyond its reasonable needs, existing and contingent, having regard to the maintenance and development of its business.[1]

The above provision is only reasonable and as already indicated, the aim of the statute should be such as to penalise the company only when it accumulates 'unreasonable or improper' part of its profits. But it is very difficult to formulate a rule and establish what is 'unreasonable' with-holding and what is 'reasonable needs of the business'. This is a pure question of fact and the decided cases in the U.K. and the U.S.A.

---

1. The other condition was that "such accumulation or failure to distribute is for the purpose of preventing the imposition of the tax upon any of the members in respect of their shares in the profits and gains so accumulated".

do not reveal any principles of universal guidance. This criterion has created a great deal of controversy and involved costly litigations and it cannot be said that it is applied successfully in these countries.[1]

Further, the vagueness of such a criterion would create unnecessary fear on the part of many companies and would compel them to distribute 'unreasonably' higher dividends.

In India, it remained almost a dead letter and only one order was passed applying this criterion from its insertion in 1930 upto the end of the year 1935-36.[2] Therefore in 1939, on the recommendation of the Income Tax Enquiry Committee, 1936, a closely held company was allowed to retain a standard percentage of its distributable profits, without regard to the reasonable needs of individual business. The Taxation Enquiry Commission reconsidered this question in 1953-54 and did not accept the suggestion to reintroduce "the vague and controversial concept of

---

1. Regarding this provision in the U.S.A. Anderson makes the following remarks: "The federal Government has not been very successful in enforcing this penalty surtax........slightly less than one half of the cases under the section have been won which is a very poor showing when it is considered that the Government chooses to prosecute those in which the most flagrant violations have occurred. Section 102 is a small tool for a big job". - Taxation and the American Economy, p. 351.

2. Income Tax Enquiry Report, 1936, p. 66.

the reasonable needs of the business".[1]

To reduce the rigour of such an arithmetical test of reasonable needs of the business, in 1955, the company was given the right to appeal to the Commissioner of Income Tax for seeking total or partial exemption from the minimum statutory distribution on the basis of their current business requirements etc. An appeal against the order of the Commissioner was allowed to a Board of Referees in the case of Indian Industrial Companies. Further, the company was allowed to carry-forward the excess distributions made in a year for three subsequent years. These provisions were withdrawn in 1957 but from 1964 a new provision has been in force. Under this, the Central Board of Direct Taxes is empowered to exempt such portion of the profits of any company (not being an investment company) as it may consider necessary to be retained to meet the development needs of the company, subject to the limit of 20 per cent of the income required to be distributed (Sec. 107A).

Section 104 companies are classified into four groups as shown in the Table 16. Industrial companies have been completely

---

1. Vol. II, p. 181.

T A B L E 16

SECTION 104 COMPANIES

(Asst.year 1966-67)

Particulars	Industrial companies[1]	Trading companies[2]	Investment companies[3]	Other companies[4]
I Statutary Percentages:				
a) Industrial Profits	Nil*	Nil	Nil	Nil
b) Other income	Nil	60%[9]	90%	60%[9]
II Rate of penal tax	-	37%	50%	25%
III Normal rate of tax:[5]			depends upon the nature of income	
a) Upto 10lakhs	55%	65%		65%
b) On the balance	60%	"		"

Notes:

1. Industrial companies - companies mainly engaged in industrial activities, that is, construction of ships, manufacture or processing of goods, mining or generation of or distribution of electricity or any other form of power.

2. Trading companies - companies mainly dealing in goods or merchandise manufactured, produced or processed by a person other than these companies.

3. Investment companies - companies whose total income consists mainly of income which, if it had been the income of an individual, would have been regarded as unearned income.

4. Other companies - this category consists of mainly of professional companies.

9. A trading company has to distribute 90% of its distributable income if its accumulated reserves exceed either the paid-up capital plus loan to the company by its shareholders or the value of its fixed assets whichever is greater.

Contd.

Note to the Table 16 Conti..

#. In the case of non-trading companies the statutory percent-age is 90 only if the accumulated reserves exceed twice the aggregate of the paid-up capital and loan capital or twice the value of the fixed assets, whichever is greater.

*. An Indian company is exempt from the penal tax if the book value of its assets being machinery or plant (other than office appliances or road transport vechicles) is Rs.50 lakhs or more (Sec.104(4)(b)).

$. Normal rate of tax on widely held company is 55%.

....

exempt from penal tax from 1964 and from 1966 the exemption has been extended to all other companies so far as the profits derived from industrial activities are concerned. Out of non-industrial income, investment companies and other non-industrial companies are required to distribute as dividends 90 per cent and 60 per cent respectively of their distributable profits. In reasonable circumstances a non-investment company can reduce this 60 per cent to 48 per cent by making an application to the Central Board of Direct Taxes.

Exemption of industrial profits from penal tax may be justified mainly by the general increase in the rates of tax on companies and also by the urgent need of the country to develop industries. It is, however, advisable to make an enquiry after a few years as to how the retained profits have been made use of.

Non-Investment (non-industrial) companies are required to distribute 60 per cent of their profits after tax. In other words, for the assessment year 1966-67, when the rate of tax is 65 per cent, they are required, retaining 14 per cent, to distribute 21 per cent of the profits before tax. This 21 per cent of minimum distribution is not unreasonable considering the f ct that in

recent years widely held trading companies, small and large, had distributed not less than 30 per cent of their profits before tax.[1] The higher rate of tax and its impact on the retained profits are "justified to reduce undue concentration of wealth".[2]

In the case of Investment Companies the statutory percentage is 90. Investment companies are very carefully treated under the penal provision for non-distribution of profits as their income is often taxed at concessional rates e.g. intercorporate dividends, and as they are in a special privileged position to enable their shareholders to avoid their personal tax liability and to invest their share of profits in the name of the company. In the U.K. the whole of the actual income from all sources other than estate or trading income of an investment company is deemed to be distributed to its members without considering whether or not the company has distributed a reasonable part thereof. In the U.S.A. retained profits of such companies are taxed at very high rates. In this connection it may be of interest to note that in Sweden, special one-time tax was imposed in 1954 on certain

---

1. Reserve Bank of India Bulletins.

2. The Finance Minister's Speech, 29th April, 1966.

closely held investment companies. It was introduced on the recommendation of the 1953 Tax Evasion Committee as an effort to induce dissolution of such companies.

Rates of Penal Income Tax

From theoretical point of view, when a closely held company retains profits in excess of its business requirements, that excess should be taxed in the hands of shareholders as if that excess profits were distributed as dividends, and the profits so taxed, when ultimately distributed by the company, should be exempted from tax in the hands of shareholders. This is the equitable and logical method of treating unreasonably accumulated profits of the company.

Before 1955, the Indian Income Tax Act adopted the above method but the entire undistributed profits of the company in default were taxed as if they were distributed, not just the portion of improperly retained profits. As this method involved all the administrative difficulties inherent in an optional partnership method of taxing companies, it was abolished on the recommendation of the Taxation Enquiry Commission, 53-54,[1] and in

1. Vol. II, pp. 187-88.

1955, a new system of imposing an additional tax at flat rates on undistributed profits was introduced.

At present, investment companies, trading companies and other non-industrial companies, in default, are made liable for a penal tax at 50, 37 and 25 per cent, respectively of the undistributed balance of profits. It seems that the difference in rates of penal tax is made on the basis of the nature of the income in the hands of companies and the extent of benefit that would accrue to the shareholders had there been no penal provision.

As already noted the penal tax is imposed on the entire undistributed balance of the profits. But an equitable and logical method should be such as to tax only the deficiency in distribution, that is, the amount by which the distribution falls short of the statutory percentage. This anomaly is the outcome of the method followed in India before 1955. Under that method it was provided, following the British system, that the entire profits retained by the company in default should be taxed as if they were distributed among the shareholders. The theory underlying such a provision is that, "if in any year there is unreasonable retention of income by a close corporation, the whole benefit of incorporation ought to be withdrawn from its members for that year

TABLE 17

PENAL TAX ON SECTION 104 COMPANIES

Sl. No.	Distribution	Deficiency in Distribution	Trading cos.		Other cos.	
			Penalty	Penalty as % of Deficiency	Penalty	Penalty as % of Deficiency
	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.
1.	55	5	16.65	333.00	11.25	225.00
2.	50	10	18.50	185.00	12.50	125.00
3.	40	20	22.20	111.00	15.00	75.00
4.	30	30	25.90	86.00	17.50	58.33
5.	20	40	29.60	74.00	20.00	50.00
6.	10	50	33.30	66.60	22.50	45.00
7.	0	60	37.00	61.67	25.00	42.00

Notes:

1. Calculations are made on the assumption that the distributable income is Rs.100.
2. 'Other companies' means companies other than industrial, investment and trading companies.

and they ought to be treated as if they were nothing but partners in receipt of a partnership income".[1] This theory does not seem to have any validity and if the penal tax is based on this theory, taxing the retained profits as dividends, the tax collected from the company ought to be refunded. It also does not seem to be reasonable to defend the present system on the ground that it is designed to act as a penalty.

Table 17 presents the anomalous effects of the present system of imposing penal tax. The penal tax as percentage of deficiency decreases with increase in deficiency and it is not equal in all cases with a given percentage of deficiency in distribution.

The penal tax once collected is not refundable and when the income on which the penalty is imposed, is ultimately distributed, the dividends are not exempted from tax. Therefore a penal tax of, say 50 or 60 per cent of the excess retention over the statutory percentage would effectively prevent companies from improperly accumulating profits. Such a scheme would be logical. It would leave much scope for the company to retain, after paying

---

1. Royal Commission on the Taxation of profits and Income, Final Report, 1955, p. 314.

the peanlty, as much profits as it requires for business purpose in excess of what is allowed and would thus act as a flexible element in the system. It would involve neither revenue loss nor any new administrative difficulty. It would, on the other hand, warrant repeal of some of the complicated provisions relating to the determination of 'distributable profits' and the procedure of imposing penal tax. Under this scheme no minute distinction need be made between trading and other companies.

Steps against avoidance of Corporation Tax

Before concluding the Chapter, mention may be made of some important measures taken in recent years to prevent shareholders from receiving the profits of the company in the form of expenses deductible in determining the total taxable income of the company. In the case of widely held companies such a device would amount to more a misuse of the funds of the company, while in the case of closely held companies it would result in evasion and avoidance of corporation tax and in some cases avoidance of both corporate and personal taxation.

An important step in this connection was taken in 1961, by putting a ceiling on company's "entertainment expenditure".

In 1964, the value of any benefit or perquisite, convertible into money or not, and arising from business or exercise of a profession was specifically made taxable and a ceiling was imposed on expenses incurred by the company (and other assessees) on advertisement or maintenance of residential accommodation, including any accommodation in the nature of guest house, or on expenditure incurred in connection with travelling by an employee or any other person. (Secs. 28 (iv) and 37(3)).