

**PART TWO**  
**COMPANY TAXATION**

## CHAPTER - VIII

### CORPORATION TAX - I

#### ON WIDELY HELD COMPANIES

The second important source of revenue is the tax on companies. Every advanced country imposes taxes on companies per se in one form or the other. However, there has been a great deal of controversy among the economists and businessmen as to the justification for and method of imposing taxes on companies.

#### Two views

There are altogether two distinct views of company taxation. The first point of view maintains that a company as such has no taxable capacity apart from its shareholders and the present method of taxing corporate income and the dividend in the hands of shareholders results in double taxation. The supporters of this view question the existence of the company as a separate tax entity and opine that there should be no tax on the company apart from the taxes on the income of the company in the hands of shareholders. It is further argued that there is no equitable basis to treat a company for taxation purposes differently from other forms of business organisations such as a partnership firm and a sole proprietorship concern. In other words, they accept

the principle of taxing profits of the company, distributed and undistributed, only in the hands of shareholders. Taxation of distributed profits creates no unsolvable problems. But as to the treatment of undistributed profits each one of them suggests a separate method and concludes that there would be no tax on companies had they distributed 100 per cent of the profits as dividends.

The second view point, on the other hand, recognises a company as a separate legal, economic, social as well as a taxable entity apart from the shareholders composing it. The supporters of this view justify a tax on the company as such on some economic principles, such as, the principle of "ability-to-pay" and the principle of "special benefit or privilege". The question of shifting of corporate tax assumes an important part in this connection.

These two views are discussed below. The discussion in this chapter is confined to the taxation of widely held public limited companies and the taxation of closely held companies is considered in detail in the next chapter.

### I. THE FIRST VIEW

#### Taxation of undistributed profits

As already noted, according to the first view the

distributed income of the company should be taxed in the hands of shareholders at the rates applicable to their personal income including the dividend income and the only problem remains to be solved is the taxation of undistributed income of the company.

Rough substitutes

The problem of taxing retained profits could safely be overcome if the idea of taxing retained profits in the hands of shareholders, only as and when they are distributed, had some basis. Such an extreme course not only has no valid basis but also, if adopted, would lead to severe inequity. Companies, on an average retain 60 per cent of their net profits, which would not normally be distributed until liquidation of the business. In other words, a substantial proportion of the profits of the company would be left untaxed under this scheme. This would discriminate deplorably against a sole proprietorship concern and a partnership firm whose entire profits are taxable, irrespective of how much of profits earned is reinvested in the business.

Further, "this treatment would be in sharp contrast to the untaxed growth in wealth that would occur if a corporate undertaking was permitted to enjoy exemption in respect of undis-

tributed profits. Moreover, this untaxed growth would be accompanied by an increase in the capital value of the company's shares and would contribute a striking instance of capital sums being built up out of untaxed income. Clearly the idea of out right exemption must be rejected.<sup>1</sup>

Very rarely it is advanced that if a 100 per cent dividend policy was enforced by law, the double taxation of corporate income could be gone away with.<sup>2</sup> This policy does not seem to be a desirable one so far as India is concerned. It is more theoretical and almost impracticable and taxation alone would not justify such a drastic policy. Retained profits of companies form a major source of saving in India and there is much to be said in favour of retention rather than of distribution of corporate profits.

A third rough substitute is the crudest method of taxing undistributed profits of the company in the form of taxes on capital gains on shares. The late Professor Simons was the proponent of this system in its general form.<sup>3</sup> Under this system,

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1. Royal Commission on the Taxation of Profits and Income, Final Report, 1955, p. 16.

2. For example: Alex Rubner, The Ensnared Shareholder, Chap.VIII.

3. See Edward D. Allen and O.H. Brownlee, Economics of Public Finance, P. 316.

the capital gains from shares would be subjected to tax at the normal personal rate as and when the capital gains were realized by sale or by bequest or gift and there would be no tax on companies.<sup>1</sup>

The fundamental assumption underlying the proposal is that the value of shares of a company in the market has stable and reliable relation to the undistributed profits of the company. Reinvested profits and consequent growth of a company, no doubt have, in normal, considerable bearing on the price of its shares, but the reflection of retained profits in the form of higher price of shares can never be exact. The value of shares in the market depends not only on the amount of retained profits, but also on current and future earning capacity and profit distribution policy of the company, the value of the underlying assets, and other economic, political and industrial considerations. There are cases where additional retained profits have no effect at all upon the share price, and in other cases their reflection in the upward movement of the share may be higher than 50%. But, excluding property companies or corporations about to be liquidated or

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1. Henry C. Simons, Personal Income Taxation, esp. Chaps. VII and IX and his Federal Tax Reform, p. 44.

taken-over, the volume of retained profits is never reflected fully in the share price".<sup>1</sup> A fall in the market prices of shares could be brought about even by artificial process and a higher rate of taxes on capital gains itself would be enough to reduce the prices of shares in the market.

Thus the fundamental assumption on which the proposal based cannot hold good and there are possibilities of the shares being disposed of at a tax advantage when the price of shares falls. Further the idea of taxing retained profits only as and when they are realised as capital gains by sale or bequest, does not seem to be reasonable and reliable, considering the current revenue needs of the Government and the fluctuating character of the prices of shares. Such a scheme would also encourage unhealthy accumulation of profits on the part of all companies. Taxation of capital gains whether realised or not, on the other hand, would in effect bring into force the partnership method of taxing retained profits in disguise.

#### A. Plan for full integration

##### Partnership Method

The most logical and equitable scheme of taxing

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1. Alex Rubner, The Ensnared Shareholder, p. 108.

retained profits is the partnership method. Under this method the profits of a company would be taxed in the hands of shareholders in the same way as the profits of a firm are taxed in the hands of individual partners. In other words, each shareholder would pay tax at his personal rate on his pro rata share of the company's total net earnings whether paid out as dividends or not.

Theoretically the partnership method, is no doubt, logical and would equalise fully the tax burden on distributed and retained profits and the question of taxing companies would not arise. But in practice, it would not only present almost unsolvable administrative problems, but would also have far reaching adverse effects on investments in shares.

The first difficulty would be the allocation of net profits of the company among its numerous shareholders spread throughout the country and abroad and the notification of their aliquot share of profits to them. This difficulty would increase enormously where the company had more than one variety of shares bearing varied interests in the net earnings of the company.

This method would not avoid the trouble of calculating the taxable income of the company. The scope for avoidance and

evasion under this method would be unlimited. Shares held in the name of nominees and identification of ownership would present additional administrative problems. A slight increase or decrease made in the net profits of the company on appeal or on reassessment would require reopening of the assessments of all shareholders and collection of additional tax or refund of tax already collected from or to each and every shareholder.

Ownership of shares of public companies changes from day to day and most of the shareholders of large public companies are interested only in current yields on shares and appreciation in the value of shares. In such a situation, who would accept to bear the tax burden on retained profits which would be distributed in a later year or would never be distributed until liquidation of the company? The investors would expect higher dividends to meet their extra tax liability. In most cases shareholders' tax liability on their aliquot share of distributed and undistributed profits of the company would exceed what they had received in cash as dividends and there would be none to venture to invest in risky enterprises. This would be more true in the case of wealthy shareholders who are responsible for the creation and growth of many large companies in this country.

Thus the partnership method is both impracticable and what is more important, undesirable. The recognition of this fact, that is, that full integration is impossible is the first step towards a separate corporation tax.

### Plans of Partial Integration

As it has become impossible to find out a satisfactory method for collecting taxes on retained profits from the shareholders, some devices have been put forth to tax them in the hands of the company itself. Thus the company has become a tax paying entity on behalf of the shareholders. The most familiar devices are:

- (1) the with-holding device and
- (2) the dividends-paid-credit approach.

The first one grows out of British experience and is, therefore, often called the British method. It has been in force in the U.K. since 1803 and we, in India, adopted it so far as the income tax is concerned till the assessment year 1959/60. The following discussion of this device, naturally, is based more on our experience.

Under the with-holding device, the company would merely be treated as a with-holding agent of the tax on retained profits. The company would normally pay tax at the standard rate on its entire net profits on behalf of the shareholders. The shareholders would be credited with the advance tax against their personal tax liability as and when the taxed profits of the company were distributed and taken into account in their personal assessment.<sup>1</sup> To shareholders who, in their personal assessment, were not liable to tax or liable to a rate lower than the standard rate, appropriate refund of tax paid by the company on distributed profits would be made.<sup>2</sup>

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1. In the personal assessment of shareholders, net dividends paid by the company would be grossed up. The formula used to gross up the dividends is:  $G = N/(1-R)$  where  $G$  = Gross dividends,  $N$  = Net dividends,  $R$  = rate of income tax on companies. Where only a portion ( $P$ ) of the profits of the company is subjected to tax the formula used is:  $G = N/(1-P/R)$ .
  2. Canada and the U.S.A. adopted a modified but a more crude form of with-holding device to allow credit to shareholders for corporation tax. In Canada, the shareholders are allowed to subtract from the total tax due on their total income which includes the dividends an amount equal to 20 per cent of the dividends received from Canadian corporations. The amount of tax paid by the company on the sum paid out as dividends is not included in the shareholders' income and no refund is allowed to low-income shareholders. In the U.S.A. for the year 1964, excluding completely from tax the first \$ 100 of dividend income, a credit against tax liability of 2 per cent of the amount of dividends in excess of \$ 100 was allowed to each shareholder. In 1965, the credit of 2 per cent was withdrawn. These devices are often called as the dividends - received credit methods. Another not closely related method was employed in the U.S.A. prior to 1954, under which exempting dividend income of the shareholders from the normal tax rate of the personal income tax, it was subject to the surtax.

Because of the administrative difficulties connected with the with-holding device, the Taxation Enquiry Commission 1953/54, recommended, as an alternative procedure, one of the familiar approaches, known as the dividends-paid credit approach.<sup>1</sup> Under this device, the company would be allowed to deduct from the total income the amounts of gross dividends paid to the shareholders and only the balance (i.e. the retained profits) would be taxed in normal at 'the standard' rate. This approach, therefore, is also known as undistributed profits approach.<sup>2</sup>

The with-holding approach would create formidable administrative problems both to the company and the department. It would involve elaborate and complicated calculations and effi-

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1. Vol. II, p. 156.

2. The salient features of the dividends-paid-credit method, as recommended by the Taxation Enquiry Commission, may be summarised as follows:- 1. Firstly, the tax at the maximum rate (of income-tax) would be imposed on the net profits less the gross dividends declared by the company in a year. 2. Where the gross dividends declared exceeded the net profits of the company in a year, the excess would be attributed to the unappropriated undistributed profits of the immediately preceding years. Naturally, where the excess dividends came out of taxed profits of the immediately preceding year, refund of tax that excess distribution suffered would be made. 3. Where the current year's profits or the immediately preceding year's profits consisted of taxable as well as non-taxable income the gross dividends would be allotted proportionately to the taxable and non-taxable portions.

cient supervision in calculating appropriate amount of tax with-held, in reporting with-holding to the shareholders and in granting refunds for over with-holding. It would cause delay and inconvenience in completing the assessments of shareholders and in granting refunds. The difficulty, in allowing credit to the shareholders, would enormously increase where the dividends were declared out of (i) any profits and gains of the company not included in its total income, or (ii) any income of the company on which no tax was payable or (iii) any amount subjected to allowance in computing the total income of the company.<sup>1</sup>

The dividends-paid-credit approach, though comparatively simple to administer, is not completely free from administrative difficulties. The difficulty of allotting distribution between taxable and non-taxable income would arise where the income of the company consisted of income exempted or income not taken into account for tax purposes such as agricultural income and interests from tax-free securities, amounts allowed by way of deduction such as development rebates and income taxable at concessional rates such as inter-corporate dividends and capital gains. It would be

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1. See sections 16(2) and 49c of the Indian Income Tax Act, 1922, as amended in 1956.

difficult to fix a satisfactory time limit for carrying back the excess distribution made in a year and an unlimited carry-back would be almost impracticable.

Further, the dividends - paid - credit system suffers from an unavoidable grave disadvantage from the view point of economic expediency. This approach, unlike the with-holding device, would impose tax on retained profits alone and discourage ploughing back of profits. The tax under the system would thus act as a penal tax for retention of profits. The adverse effects of such a measure would be fatal to the growth of corporate sector in the country. The effects of this system on new and growing firms and small companies would be more serious as it would reduce available internal resources for expansion. Tax burden would be heavier on them than on old established companies. This method with present day higher rate of taxes might encourage debt financing. Most of these effects of a tax on undistributed profits of the company were realised in the U.S.A. in 1936 when it introduced the undistributed profits tax (eventhough, as a supplement to the regular corporation tax. We, in India, experienced the adverse effects of this kind of tax in 1919 by imposing a super-tax on the undistributed profits of the company at rates

varying from 6.25 to 16.75 per cent over and above Rs. 50,000.<sup>1</sup>

It may also be pointed out that, as the standard rate of tax on individuals could, usually, be linked with these devices, taxation of companies would lack flexibility and it would be rather difficult to bring about desired changes in one without affecting the other. "Mr. Growthier has gone so far as to suggest that the rates of company taxation in recent years (in the U.K.) have arisen more by chance than design. He argues that the standard rate was increased because it was desired to increase the progression of the personal tax structure and the unplanned result of this was an increase in the burden upon companies."<sup>2</sup>

If any one of these devices could integrate, atleast to a reasonable extent, the corporate and individual income taxes,

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1. "As the tax was extended to undistributed profits of companies and partnerships, it was to the interest of business to distribute more in dividends than was justified by their financial position. There was therefore an indirect penalty on those companies and firms which wanted to strengthen their reserve funds. The long-period effect of such a system of taxation was bound to be injurious to industrial development in a country like India, handicapped for want of industrial capital. Fortunately this defect was remedied before many years were out" - i.e. in March, 1920. See J.P. Nylogi, The Evolution of the Indian Income Tax, p. 145.

2. David Walker, "Some Economic Aspects of the Taxation of Companies", The Manchester School of Economic and Social Studies, Vol. 22 (1954), p. 1.

the administrative difficulties and other effects connected with them could be tolerated. But they prove to be completely inadequate measures to equalise the tax burden on distributed and retained profits of the company for the following reasons. (This is the next step towards a separate corporation tax).

1. Under both these approaches the retained profits of the company are taxed with the idea that it would equalise to a greater extent the tax burden on distributed and retained profits. Taxing companies at 'the so called standard' or 'maximum' rate under these devices, no doubt, resulted in taxing the distributed and retained profits of the company approximately at the same rate, so long as the rate of income-tax on individuals was more or less flat without high progression; so long as the shares were held mainly by upper class investors and so long as the profits earned and distributed by the company were approximately equal. But the above conditions have wholly changed. Individuals are no longer subjected to a flat rate of tax. As already noted the progression of the present rate structure is very steep, the rates varying from zero to 80-85 per cent, subject to many concessions rebates and exemptions. Individuals having considerably low income also invest in corporate securities. Large retention of profits by

companies for development and other purposes has also become a permanent feature of the corporate financial policy.

Under this new step-up, there would be "no theoretical justice in taxing undistributed profits at the standard rate".<sup>1</sup> It is also impossible to fix a rate, apart from the standard rate, which would bring about an approximate equivalence in taxation of distributed and retained profits or of corporate profits as a whole and other non-corporate income. These approaches, then, would at the most help to impose a certain amount of tax on undistributed profits instead of leaving them untaxed. Naturally the question arises why should such complicated and round about devices be adopted for this simple purpose?

2. What is more grave is that the credit allowed under these methods would often exceed the tax collection. As it would not be possible to calculate the rates of tax imposed on the profits accumulated by the company from time to time, the credit would in normal be allowed under the with-holding device at the current rates in force. In these days of fast increasing rates

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1. Royal Commission on the Taxation of Profits and Income, Final Report (1955), p. 15.

of taxes, the credit under this kind of treatment would exceed the actual tax collected on the accumulated profits. The anomaly would be serious where such a credit was allowed in respect of distribution made at the time of liquidation of the company out of profits accumulated ever since its incorporation. Special elaborate provisions would be necessary to avoid this kind of anomaly where the dividends were paid out of capital gains and inter-corporate dividends which are often taxable at a concessional rate and in cases where the double taxation avoidance relief was granted to the company.<sup>1</sup>

Under the dividend-paid-credit approach also the refund would exceed the actual collection of tax, if, in order to avoid complication, the refund on excess distribution made in a year was allowed at the current rates of tax. This would be more so where there was no time-limit to carry-back the excess distribution.

3. The incidence of the tax on retained profits is another important factor. If the ultimate incidence of the tax is not on the retained profits, these methods would utterly fail

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1. See Section 49c of Indian Income Tax Act, 1922.

in their purpose. But there is no satisfactory doctrine of incidence and no empirical method has been evolved to measure the incidence of the tax.<sup>1</sup> However, it can no longer be maintained that the traditional theory of incidence is of any value. It assumes that a business concern will always aim at 'maximum profits' and the corporate tax, therefore, cannot be shifted, whether there is competition or monopoly. Though the corporate tax cannot be considered merely as a general sales tax, there is every likelihood of a part of corporate tax being shifted, at least in the long run, in the form of higher prices. In recent years there seems to be a growing tendency among economists and businessmen to recognise it. This newer theory doubts the validity of traditional assumption that business concerns aim always at 'maximum profits'. It argues that the modern administration of prices is practically opposite to that assumed by the traditional theory. Fair return

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1. Comparison of the indices of general price and taxes on companies and the co-efficient of co-relation of these two indices is sometimes adopted. See H. Pershad, Indian Taxation During and After World War II, Ch. ps. VI and VII and S. Ambirayan, The Taxation of Corporate Income in India, pp. 224-229. This system is completely misleading and any conclusion drawn from it is bound to be incorrect. A somewhat improved method is employed by Kaldor (See his book An expenditure tax, p. 148 ff). For a more mathematical approach reference may be made to:- Mariah Argyaniak and Richard A. Musgrave, The Shifting of the Corporation Income Tax.

on equity capital forms, atleast in the long run, a part of cost and "prices are fixed in advance of production on the basis of cost schedules and estimates of probable demand, among other conditions".<sup>1</sup> Small concerns may not be able to fix the prices but they will merely follow the prices determined by dominant firms.<sup>2</sup>

The sample surveys undertaken in the U.S.A. reveal that, in recent years, the majority of the managements of manufacturing companies consciously take the corporate tax into account in determining prices<sup>3</sup> and "a larger portion of aggregate corporate income taxes has been recouped through higher prices than in the period between the two wars".<sup>4</sup>

It follows from the above discussion that a full integration of taxes on retained and distributed profits is a

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1. Lewis H. Kimmel, Taxes and Economic Incentives, p. 23.
2. G.G. Groves, Post-war Taxation and Economic Progress, p.28 and Kolcor, The Expenditure Tax, p. 169.
3. Some companies may do so unconsciously and some companies may follow the prices fixed by the majority.
4. Lewis H. Kimmel, Taxes and Economic Incentives, p. 30.  
A.S. Mackintosh has concluded from some recent case studies that taxes on profits are to some extent shifted forwards. Refer his book, The Development of Firms (1963), pp. 134-6.

practical impossibility and what all the partial integration methods can do is that they impose some tax on the company basing on the retained profits. Any rate of tax fixed could have little connection with that borne by the distributed profits. It would be arbitrary and the tax burden would differ from one company to another depending upon the income of the shareholders and the ability of the company to shift the tax.

#### An alternative approach

It would not, therefore, be more arbitrary or inequitable if some tax is imposed on the company based on its entire profits, instead of on its retained portion of the profits alone. This method may be referred to as undistributed profits tax-spread over method. (This is the third step towards a separate corporation tax). The following considerations would go further to strengthen this argument.

1. In the long run the tax burdens on different companies would not vary much as over a period of years the difference in the rates of distribution between companies would tend to be reduced, even though in a particular year the distribution by some companies may exceed their total earnings, the distribution

by others forming only a minor part of their earnings. When all the companies are viewed as a whole the rate of distribution made in a year does not differ much from that made in a previous year.

2. Even if there is any difference in tax burdens between companies and "even if one assumes that the taxes are not shifted but effectively reduce the net profits of the corporations, it does not always follow that the incidence of these taxes falls on any particular group of shareholders. This is the case when the tax is directly passed on in the form of lower dividends. To the extent, however, that the effect of the tax is to reduce not the dividends but the net amount retained by corporations, the incidence is borne by future, rather than by present shareholders; and it takes the form of a lower rate of long-run appreciation in share values (resulting from a lower rate of growth of assets and earning power) than would have occurred otherwise.

In the case of any particular company, however, the connection between accumulated reserves and share values can vary within very wide limits, so that it is uncertain how quickly or slowly the growth in reserves is transmitted into market valuations. Since shareholders may switch their holdings from one company to another at any time, the 'future' shareholders of a company need

not be the same persons as the present shareholders so that it is not possible to assert that any definite group of shareholders suffers discriminatory treatment when the retained profits of one company are subject to a different rate of effective taxation than the retained profits of another. For this reason one cannot apply the same notion of 'fairness' when it comes to the allocation of the tax burden between corporations as one can and should apply to the allocation of taxation between different individuals. For ..... the benefit that individuals derive from retained profits is in the form of capital gains; the amount of capital gains which particular individuals make on particular shares depends on their timing of purchases and sales and not on the amount of undistributed profits during any particular period. Hence fairness in company taxation does not ensure fairness in the taxation of individuals; nor does 'unfairness' in the form of unequal incidence of tax on the undistributed profits of different companies cause 'unfairness' in the taxation of individuals. All that can be asserted is that a given total amount raised in taxation from corporations taken as a whole imposes a corresponding burden on the body of shareholders of companies as a whole.<sup>1</sup>

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1. The Minority of the British Royal Commission on the Taxation of Profits and Income, Final Report 1953, p. 385.

3. No country now seems to have only a tax which is refundable to the shareholders as and when it distributes its profits. Many of the violent opponents of a separate corporation tax are ready to accept or tolerate a lower percentage of non-refundable tax on the company as such. Where, thus, only a part of the tax on the company was based on retained profits, the effective rate of tax under the undistributed profits tax-spread over method would not differ much from that under its alternatives. The following Table may make this point clear.

Table - 14

Profit before tax = Rs.100  
Total tax = Rs. 50

Tax		with-holding or Dividend-paid-credit device				Tax under undistributed profits tax spread-over method	
non-refundable	non-refundable	Effective tax in connection with the distribution as percentage of profits before tax.					
		30(a)	35	40	45(b)	(b)-(a)	
40	10	38.0	36.0	34.0	32.0	6.0	35.0
30	20	41.0	39.5	38.0	36.5	4.5	38.8
20	30	44.0	43.0	42.0	41.0	3.0	42.5
10	40	47.0	46.5	46.0	45.5	1.5	46.3

Assume, for example, that out of 50 per cent of total tax, 30 per cent was refundable; that the companies distribute 35 to 40 per cent of their profits and that the rate of tax under the undistributed profits tax-spread over method was fixed at 38.8 per cent. Where the effective tax rates on various companies under these two systems were compared, the tax increase or decrease under the undistributed profits tax-spread-over-method would not be more than 2.25 per cent.

Taxation of the company on the basis of its entire profits would be simple to administer and would be free from the defects of the dividend-paid-credit device from the point of social interest. The tax under the proposed scheme would fall less heavily on expanding companies which usually plough back a greater proportion of their profits than on stagnant companies. Further, the tax system under this scheme would enjoy complete flexibility.

## II. THE SECOND VIEW

Thus, even if the company is considered merely as an aggregate of persons, one is compelled to recognise it as a separate taxable entity. It is not so, as some asserted, because that the administrative techniques have not been developed, but

mainly because of the characteristics of the company itself. In a developing or developed economy, the company is not only a legal entity but also economic, social, and tax entity. (This is the final step towards a separate corporation tax) "..... as a country progresses in its programme of economic development, corporate taxation should become distinct from personal taxation."<sup>1</sup>

A corporation is an artificial independent person created by law with a distinctive name and a common seal. It is not like a partnership firm, the mere aggregation of its members. It is a legal entity and something different from its shareholders. It has right to make rules and by-laws. It has right to sue and can be sued. It has authority to enter into contracts with its shareholders and others and to convey better title. The shareholders cannot bind the company by their acts; they are not its agents. A member can both own its shares and be its creditors. A shareholder can sell his shares at any time as he likes without the consent of other shareholders and without affecting the life of the company. The company, thus, has perpetual succession and it is independent of the lives of its members.

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1. The United Nations Fiscal Commission, Corporate Tax Problems, 1952, p. 63.

A shareholder has not only "limited liability". He has also no interest in the property of the company including retained profits. He has a right to participate in the profits only if and when the company decides to divide them. He cannot, except in rare instances, compel directors to declare dividends or more dividends than what has been recommended by them.

The shareholders have little or only very remote control of the affairs of a large public company. They occupy a peculiar position of an investor in between a creditor and a owner. According to Schumpeter: "The only realistic definition of stockholders is that they are creditors (capitalists) who forego part of the legal protection usually extended to creditors, in exchange for the right to participate in profits".<sup>1</sup> A large corporation, in Mason's terms, "converts owners essentially into rentiers".<sup>2</sup>

The natural outcome of the growth of corporate form of organisation is the separation of ownership and control, which, in turn, is responsible for the tremendous growth and dominance

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1. Quoted by Richard Goode, The Corporation Income Tax, pp.18-19.

2. The Corporation in Modern Society, 1961, p. 15.

of the corporate sector in the economy. Though legally the virtual control of the affairs of the company vests in the hands <sup>of</sup> a few representative shareholders known as directors, in reality "It is a fiction ..... to regard the board of directors as the personal representatives of the shareholders, to whom are delegated the ultimate responsibilities of ownership in the selection of managers to carry out the policies of the owners. It seems that in the large corporation the more usual situation is for management to select the directors."<sup>1</sup> The increasing professionalisation of the management seems to be one of the characteristics of corporate form of organisation and in actual practice, directors often follow the advices of hired management.

It is not unusual that a company is controlled by minority shareholders, with a block of 10 to 20 per cent of the voting rights. It is because of the dispersal of shareholders over a large number of persons inside and outside the country, a majority of whom take no active part in corporate decisions, and the growing importance of impersonal and passive shareholders like companies, investment trusts, insurance companies banks and

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1. Richard Goode, Op. Cit., p. 21.

other institutional investors, Government or non-Government, without a significant share of ownership, a corporate group can have operational control over a number of companies by a process of inter-corporate investment often supplemented by powers obtained under managing agency agreements and by the buying and selling of shares by investment companies belonging to the group and by interlocking of directors.<sup>1</sup>

In recent years a new image of the corporate sector has emerged. According to this the company is deemed to be a social entity. It unites investors, large and small labourers, managers, lawyers, auditors, customers, suppliers of raw materials and politicians and exercises an important influence on the entire community. It is a chosen instrument of law and an accepted instrument of social policy for carrying on a large part of the economic life of society. The risks of the company are borne not only by the shareholders but also by creditors, labourers and others. The directors should, therefore, be considered to be the trustees not merely for shareholders but for the entire community. They are the administrators of a novel community system. "Industry

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1. Report of the Committee on Distribution of Income and Levels of Living, Part I 1964, pp. 37, 38 and 46.

in the twentieth century" an English writer comments, "can no longer be regarded as a private arrangement for enriching shareholders. It has become a joint enterprise in which workers and management, consumers, the locality and Government, all play a part. If the system which we know by the name of private enterprise is to continue, some way must be found to embrace the many interests which go to make up industry in a common purpose".<sup>1</sup>

The company should, therefore, be considered as essentially a partnership between the promoters, organisers, shareholders and the society as a whole rather than as a 'property' solely belonging to the shareholders. It can no longer be maintained that a company exists only in the contemplation of law and when the company makes profits, in excess of a reasonable return on sharecapital, it cannot be claimed that the excess profits should be passed on to the shareholders intact. The Government, on the other hand, has every right to participate directly in that surplus profits in the hands of the company on some equitable bases.

#### Theories in defence of Corporation Tax

A separate corporation tax is often justified by

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1. Quoted by D.L. Mazumdar, "The New Images of Joint-Stock Companies", Commerce, 29th April, 1961, p. 791.

proving that a company is a legal as well as economic entity apart from the shareholders, on one or both the following principles: (1) the special benefit or privilege theory (2) the impersonal ability of the corporations to pay tax.

Sometimes the corporation tax is advocated, applying, only to companies, theories used to justify a general business taxation on administrative and some other consideration.

### General theories

Important theories on general business taxation are: (1) the general benefit theory (2) the special and social cost theory and (3) the social control and regulation theory.

The main reason for limiting the application of a general business tax advocated on these theories to companies alone is that of administrative expediency. A general business tax would create almost unsolvable questions; what constitutes business? and what activities are to be treated as business? The tax when imposed on companies alone would, on the other hand raise no such questions. Companies are created and clearly defined by law. Compared to unincorporated concerns, companies present

no difficulty in identifying the ownership of the business and its income. They are compelled by law to maintain a registered office and regular accounts on which the tax could easily be based.

"Administrative expediency, then, has played a considerable part in the continuation of taxes upon corporations which are not applicable to other forms of business".<sup>1</sup>

Other reasons for limiting the applications of the general business tax to companies alone are their impersonal character and their predominant and monopolistic position in the business world.

The general benefit or protection theory is the oldest theory used to justify business taxation. It states that each business should pay for the benefits received from the Government in the form of numerous services. Business enterprises cannot exist without the laws establishing, and safeguarding the rights of property, the service of courts, police, army etc. The Government maintains law and order and a stable currency and aids business in foreign markets.

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1. Merlin H. Hunter, "Shall we Tax Corporations or Business?", American Economic Review, Vol. XXVI (1936), p. 84.

No doubt, as the critics of this theory point out, the Government exists primarily not for the benefits of business, but for the benefit of the society as a whole, and the precise allocation of the burden of Government expenditure amongst its various activities, is almost impossible. Nevertheless, the expenditure of the Government facilitates the business in its income-producing activities and an approximate special charge on all business, independent of the benefits enjoyed by individual concerns, does not violate the principle of equity.

The second or the cost approach theory of taxation, consists of two kinds of costs: special and social cost. Some business<sup>es</sup> demand public services involving some 'special cost' to the Government. It has always been regarded proper to charge such business enterprises with the costs of any special service furnished, for instance, the cost of supervising the activities of companies handling dangerous equipment and materials.

The social cost approach, on the other hand, justifies a tax on business in so far as the society is adversely affected by business activities and in as much as the eventual correction of this involves increased expenditure on the part of

the Government. The private business and industrial activities cause evils and inconvenience to the physical and human resources of the society. Examples are the damages caused by air and water pollution, over crowding of urban areas, industrial accidents, occupational diseases and technical unemployment.

The validity of the arguments in favour of the special and social cost theory cannot be questioned. In fact these approaches in general widen the field of the general benefit theory. In special cases, the special cost theory justifies a special charge on individual firms rather than a general tax on all business enterprises or on all companies.

Finally the social control or regulation theory favours taxation as an effective weapon to restrict the concentration and abuses of economic power in the hands of giant industrial concerns. This theory may be considered as specially applicable to companies as it is designed to control the activities of giant business enterprises and as the giant business enterprises are invariably companies.

The present level of company taxation, as compared with a lower rate of tax or no tax on companies, limits the

capacity of enterprises to expand their activities and act, at least to a limited extent along with taxes on individuals as a machinery to redistribute income and wealth in the community. It is apt to note here, that in India, the tax on intercorporate dividends is advocated partly on the principle of social-control. But taxation itself is too limited and crude a means of limiting the growth of big businesses. Also the magnitude of business activities or the size of profits of a company alone cannot be a conclusive proof of economic concentration and monopoly control. The present method of taxing all companies at a flat rate cannot be said to be mainly designed to prevent economic concentration. If the main purpose of taxation was to prevent economic concentration, it would call for a different kind of corporation tax e.g. heavy tax on undistributed profits or on big business alone.

All considered, the general benefit theory which includes the social cost in its widest form, and the social control or regulation theory do recognise a tax on companies but the recognition is very vague. There are present some elements favouring tax on all kinds of business enterprise rather than on companies alone. Further these theories do not clearly

indicate that the tax on companies must be in the form of tax on their net income.

### Special theories

Most often a corporation tax is justified not on the above theories, but on the theory of special privilege or benefit and/or 'ability-to-pay' principle.

### The special benefit or privilege theory

Perhaps most commonly a tax on companies per se is justified on what is called "the special benefit or privilege theory". A company when incorporated under the law is endowed by the Government with a life and a common seal. The company, then, is in a privileged position to an individual proprietorship concern or a partnership firm, to raise ample resources from the public conferring on them limited liability, easy transferability of shares and the safe type of sleeping partnership. It enjoys stability and perpetual succession. Because of these characteristics, the company grows in size, enjoys all the advantages of large scale operations and earns bigger profits. It dominates other forms of business organisation. Then, it is only fair for the Government to participate with the profits of the company.

In India, the corporation tax, when introduced in 1920 in the form of super-tax on companies, was justified on the above principle. Sir Malcolm Hailey, the then Finance Member said: "It is considered justifiable to tax a corporation partly because it enjoys the use of what may be called public capital, but even more because its shareholders enjoy protection against liabilities incurred upto the amount of their shares".<sup>1</sup>

The privilege theory is not free from criticism. The critics of this theory consider that it is illegal and unscientific to base the tax on companies on the privilege principle. It is argued that the privileges are granted to the company only to serve the public interest and the advantages of incorporation are not confined to a class. They are open to all and the era of special charters granted by the sovereign in exchange for monopoly is a thing of the past. Incorporation available to all is not a special privilege that justifies a special tax on companies.<sup>2</sup> Some prefer to limit application of the benefit principle to cases in which there is a direct correspondence between a specific tax and a specific Government service as for instance, in the case

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1. Proceedings of the Indian Legislative Council, 1920.

2. H.L. Lutz, Public Finance.

of automobile taxes and the construction and maintenance of roads.<sup>1</sup>

The second argument against the specific privilege theory is that it provides no satisfactory clue as to how taxes should be distributed. It is almost impossible to measure the benefits received by a company by incorporation, and the present practice of imposing taxes on net income cannot be said to be based on the privilege theory. The volume of profits is no measure of the privilege and the present corporation tax which exempts from tax companies showing no profits or showing loss violates the principle that it is based on privilege theory.

Further, it is argued that if the corporation tax is really a tax on privilege, it should be levied when the privilege is granted, that is, when the joint-stock company is incorporated and it should not be based on the net earnings of the company.<sup>2</sup>

None of the above arguments seems to be conclusive. The benefits of incorporation, no doubt, are granted by the Government only to serve public interest and they are more or less,

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1. For example see: Gerhard Colm, "The Corporation and the Corporate Income Tax in the American Economy", American Economic Review, Vol. 34 (1944), p. 490.

2. P.C. Jain, Finance and Planning in India, 1959, p. 191.

freely available to all. But it is not essential that they should be confined to special interests to justify a tax on companies and the advantages of incorporation and of holding shares do remain irrespective of the fact that they are made available to all. Indeed, "the argument that the availability of the privileges of incorporation to all destroys their economic value seems to confuse 'benefit' with exchange value".<sup>1</sup> "Benefit" of certain rights and privileges is not, like the value of goods in the market, governed by "supply and demand" principles. It also does not seem to be correct to imagine that privileges granted should be in the form of pure monopoly power or in the form of specific benefits to justify tax on companies.

Further, the fact that it is impossible to measure exactly the benefit of incorporation cannot nullify the validity of the theory. As a matter of fact "no general theory indicates both a tax base and an appropriate rate schedule" and "if it is agreed that the benefit theory does justify special taxation of corporations, we can try to pick out some standard or base that seems reasonably well correlated with benefits."<sup>2</sup>

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1. Richard Goode, *The Corporation Income Tax*, 1951, p. 29.

2. *Ibid.*, pp. 26 and 29.

Though the advantages of incorporation are inherent in the corporate form of organisation without regard to whether or not business is done at a profit under such a form of organisation, it seems to be reasonable and also expedient to base the corporation tax on net earnings of the company. A tax on companies is justified not merely for granting certain privileges to them, but for the reason that these privileges when utilised really increase the normal return on the capital invested. The tax is paid by a company not "to be or to become" a company but "to do or to act" as an incorporated concern and earn profits.<sup>1</sup>

Moreover, the Government is not merely an authority to grant privileges of incorporation having no interest in the welfare of the incorporated concerns. The Government, on the otherhand, is really a partner of all incorporated concerns in the sense that it provides certain privileges and takes a part of the profits earned utilising the privileges provided. Naturally, if any incorporated concern incurs a loss, the Government as a partner should bear a share of that loss. Then it is, by no means, unreasonable to exempt from tax, companies having no

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1. See Edwin R.A. Seligman, *Essays in Taxation*, 1923, p. 225.

profits or to allow "carry-forward and set-off" of the loss incurred by a company in a year against its future profits.

All things considered, the privilege theory does justify a tax on companies and indicates that the tax should be based on the net earnings of companies.

### Ability-to-pay principle

There seems to be only a few supporters of the impersonal ability of a company as the basis of corporation tax. Interpretation of "ability-to-pay" is more theoretical and involved. We, therefore, can have nothing more than a limited survey of the criterion of ability-to-pay as applicable to corporation tax.

According to Adams Smith's first canon of taxation, the subjects of every state ought to contribute toward the support of the Government "as nearly as possible in proportion to their respective abilities". He goes on to explain that the measure of ability in his opinion, is the revenue enjoyed under the protection of the state and that taxation should be in proportion to revenue. But this simple interpretation has not always

been accepted. Then the question arises how is "ability-to-pay" to be measured?

The term ability-to-pay is interpreted variously from time to time as including subjective element of sacrifice and objective element of faculty or earning power.

The development on the subjective side of ability-to-pay principle leads to the well-known sacrifice theories viz., the equal sacrifice theory, the proportional sacrifice theory, the equimarginal sacrifice theory and the minimum sacrifice theory. "According to the equal sacrifice theory, taxes should be so levied that every tax payer would give up the same absolute amount (equal area) of utility as every other taxpayer; according to the proportional sacrifice theory, each tax payer would surrender the same proportion of the total utility of his income; according to the equimarginal sacrifice theory, the marginal disutility incurred by each taxpayer should be equal; and according to the minimum sacrifice theory, the sum of the areas of utility sacrificed, both directly and indirectly, by all taxpayers 'shall be as small as possible in proportion to the revenue secured'.<sup>1</sup>

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1. Elmer D. Fagin "Recent and Contemporary Theories of Progressive Taxation", The Journal of Political Economy, Vol. 46 (1938), p.456.

The sacrifice theories, in their fully developed form, are mainly based on the principle of diminishing marginal utility of income of the taxpayers which, in turn, is based on psychology of the taxpayers. If the ability-to-pay principle is taken in its 'hedonistic terms', it cannot be applied to corporation tax. Ability-to-pay in its subjective terms is concerned with personal feelings and sacrifice and the corporation as such or any other inanimate thing, can feel no sacrifice. This is the ground on which the ability-to-pay theory has been rejected by almost all students of public finance as a justification for the corporation tax. However, it remains to be seen why the company cannot as an artificial person feel some sacrifice in paying tax as such.

The sacrifice theories have, however, not been accepted as the correct interpretation of ability-to-pay principle. It has been proved that these theories are formed on outmoded psychology and that the fundamental assumptions underlying them do not hold good.<sup>1</sup> "It is a shallow and narrow interpretation of the ability principles", Adams says, "that tests its every

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1. Cf: Eloner L. Fagon, Op. Cit. and M. Slade Kendrick, "The Ability to Pay theory of Taxation", American Economic Review, Vol. 29 (1939), pp. 92-101.

application by the effect of the tax upon the consumer, which surveys man, the tax-payer, only as one who clothes his back and feeds his body. There are many valid varieties of the ability-principles".<sup>1</sup>

Sometimes incorporation in conjunction with income is used as an index of ability. It is argued that each company is an artificial person having a peculiar ability to earn income. This ability except in personally conducted business is distinct from the personal abilities of the owners to pay taxes from their income. Because of its large resources collected through limited liability device, the company is in a position to take greater risks, make bigger investments and earn proportionately larger incomes. Thousand separate capitals of Rs. 100/- each could not in normal, make as much profits as a single capital of Rs.1,00,000/-. It is here the extra ability of companies lies over and above the ability of distributed profits in the hands of shareholders.

This line of argument combines benefit or privilege principle with the ability-to-pay criterion and recognises companies as separate taxable entities. Adams seems to appreciate the

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1. "Fundamental problems of Federal Income Taxation", quarterly Journal of Economics, Vol. XXXIV (1921), pp. 527-56.

existence of the impersonal ability-to-pay in a business concern alongside the personal one. "Most good business taxes", he says, "combine or represent at once both the ability and the benefit principles". Taxes on companies, according to Adams, "are not taxes upon the individuals to be judged by the sacrifices which they impose upon him, but a prior claim of the State upon the private profits which public expenditure or the business environment maintained by the State have in part produced.....business taxes are not antagonistic to the ability principle, they recognise.....a species of ability-to-pay created by the activities of the state or by a 'conjuncture' afforded by the community".<sup>1</sup>

The faculty theory as interpreted and defended by Seligman also recognises the above truth. "In the United States... the federal corporation tax and the corporate franchise in our Commonwealths", Seligman remarks "are all of them referable at bottom to this newer idea of social or legal privilege as augmenting the faculty or ability of the taxpayer whether individual or corporation".<sup>2</sup> However his interpretation of ability-to-pay is highly subjective. He relates to the principle of ability

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1. Given as footnote by Paul Studenski, "Towards a Theory of Business Taxation", Journal of Political Economy, Vol. XLVIII (1940), p. 634.

2. Essays in Taxation, p. 341.

or faculty, not only "the privilege theory without incurring any of its extravagances" (on the side of production of wealth) but also the psychic element of sacrifice (on the side of disposition of wealth).<sup>1</sup>

J.A. Hobson distinguishes the 'cost' element from the "surplus element in income and claims the surplus element in income as the true measure of ability-to-bear taxation. Hobson defines surplus income as those "elements of income which do not 'dry up' under taxation and the taxation of which does not disturb industry".<sup>2</sup> however, "By ability in present day usage is meant simply economic well-being or the over-all level of living enjoyed by the taxpayer"<sup>3</sup> and great stress is made on the equitable distribution of wealth in the community. Social importance or moral worth of the income tax is looked into and difference is made between 'earned' and 'unearned' income.

No one can precisely say what would happen if there were no taxes on companies and the corporate profits were taxed

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1. Ibid, p. 340.

2. Taxation in the New State, 1919, p. 25.

3. John F. Due, Government Finance, p. 109.

directly in the hands of shareholders at progressive rates applicable to their unearned income. Though it does not seem to be possible to justify a separate corporation tax purely on ability principle, a flat rate of tax on companies, on the other hand, may not violate fully this principle, considering the facts that the corporate profits are an important source of large incomes and fortunes and the securities of a corporation are often held by the upper and middle income groups. There is also some justification in giving weight to the argument that the companies are in a specially privileged position to earn huge profits and the shareholders often resemble more a sleeping partner of a firm and consequently the companies as such have some extra ability to pay tax on their profits before they are distributed and taxed in the hands of shareholders.

### Conclusion

All things considered, it is well-nigh impossible to integrate fully the corporate and individual taxes. Neither it seems to be desirable. A large public company in the twentieth century cannot reasonably be considered as a mere aggregate of individuals. To avoid confusion, it is better to consider the

inherent right of the company to have a part of its profits undistributed as one of the privileges of incorporation or as a factor which increases its ability-to-pay tax, rather than as a source attracting a separate rate of tax.

Integration methods of taxing undistributed profits would be of no advantage either to the revenue or to the shareholders. In some quarters it is maintained that a credit allowable under the with-holding device to the shareholders would encourage investment in shares.<sup>1</sup> This argument assumes that the company would be taxed at the same rate whether or not such a credit was allowed to the shareholders. "But since the net revenue from the tax would be very different in two cases, no such supposition would be justified. From the shareholder's point of view, on the other hand, what matters is the amount by which his profits are reduced through corporate taxation, not the precise form in which they are reduced. Since not only the rates of profits taxation but the nominal dividends declared by the companies can be expected to be adjusted to the difference in the mode of charging, it is not clear why the shareholders are put under any disadvantage

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1. S.S., Taxation Enquiry Commission, Vol. 11, p. 153.

under the one system as against the other".<sup>1</sup>

The best method of taxing the company, thus, is to impose a non-differential rate of tax on the whole of its profits. It needs hardly be expressed that this tax should be flat without progression. The fact that a company makes larger profits than others does not go to prove that the company is or its shareholders are rich so as to attract a higher rate of tax.

Separate taxation of companies and their shareholders is simple to administer and would add greater flexibility to the tax system. It is a fallacy to maintain that taxing both the profits of the company and the dividends in the hands of shareholders results in double taxation. Neither of the views of the corporation tax indicates exactly how much tax should be imposed on the company. The level of corporation tax should, therefore, be determined mainly by the likely effects of the tax rates to be fixed on the growth of private corporate sector in the country and also by the current revenue needs. And any logical criticism against the corporation tax should be made by substituting for "double taxation" such terms as "higher or relatively higher

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1. Minority of the Royal Commission, Final Report, 1965, pp.363-4. If it is considered that some concessions should be given, it is advisable to grant some concessions direct to shareholders and for this purpose the U.S.A. practice may be followed.

taxation".<sup>1</sup>

### Corporation Tax in India

In India, the scheme of taxing companies and their shareholders has passed through many stages, since the introduction of the Indian Income-Tax Act of 1886. Important stages are noted below:

1. In 1886 itself, companies were recognised as a separate category of assesses, and income-tax was charged on the net income of companies at a flat rate of 5 pies in the rupee. But dividends declared out of taxed income of companies were altogether exempt from tax in the hands of shareholders.

2. In 1917, a super-tax was introduced and charged at rates varying from 1 anna to 3 annas in the rupee on the profits exceeding Rs. 50,000. This was made applicable not only to individuals but it was also extended to the undistributed profits of companies, firms and joint Hindu families. The reason was to

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1. Goode, The Postwar Corporation Tax Structure, Reprinted in  
Loris I. Bittker's Federal Income, Estate and Gift Taxation,  
1964, p. 592.

bring under taxation the abnormal profits made as a result of war conditions. Only for want of a more effective method a super-tax of this kind was decided upon<sup>1</sup> and the distributed portion of profits of a company was taxed to super-tax in the hands of shareholders.

3. The Income-tax Act 1918, introduced a new provision by which the net dividends received by the shareholders were, for the first time, taken into account (only) for calculating the rate of tax applicable to other incomes of the shareholders. The dividends, however, were continued to be exempt from income-tax in their hands.

4. In 1920, the basis of imposing super-tax on companies was altered and the super-tax was charged on all income i.e., distributed and undistributed income of companies, in excess of Rs. 50,000 at a flat rate of 1 anna in the rupee. A tax on companies as such was recognised and the shareholders were not allowed any credit in respect of super-tax paid by the company.

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1. "Whilst thus extending the super-tax to the undistributed profits, the Government had no desire to be harsh or unsympathetic. To make the tax as acceptable as possible, the Government allowed as deduction a sum not exceeding 10% of the whole profits before the taxable undistributed profits was arrived at" - J.P. Niyogi, The Evolution of the Indian Income Tax, (1929), p. 141.

5. The Income Tax Act 1922, introduced a change in the treatment of dividends in the hands of shareholders and the dividends were taken into account for calculating the rate applicable to other income of shareholders, not at the net figure but at the "grossed" figure. The "grossed" figure included the portion of income-tax paid by the company on the profits out of which the dividends were declared. The shareholders, however, were allowed a refund of income-tax on the 'grossed' dividends calculated at the difference between the company rate of tax and their personal rate of income-tax.

6. The Income-Tax (Amendment) Act of 1939, restricted the credit or the refund allowable to the shareholders to the extent of proportionate income-tax paid by the company on the profits out of which the dividends were declared viz., the difference between the gross dividend and the net dividends.

7. In the same year, the exemption limit of Rs.50,000 was withdrawn on the recommendation of the Taxation Enquiry Committee of 1924/25 as endorsed by the Income Tax Enquiry Committee of 1936<sup>1</sup> and the super-tax was charged on every rupee

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1. Income Tax Enquiry Report 1936, p. 16.

of the *Income* of companies.

8. Recently in 1959, as a first step to simplify the system of taxation of companies and the shareholders, a new provision was introduced for deducting tax at prescribed rates from dividends at source.

9. In 1960, provisions allowing credit of income tax paid by companies to the shareholders were withdrawn.

Thus, we have, at last, after passing through almost all stages in the growth of the single corporation tax, come to recognise fully companies as separate taxable entities apart from the shareholders. At present, in most of the countries in the world, "including America, Europe, Australia and South Africa, company profits are taxed once and for all by a single tax at a uniform rate, for which little or no credit is given to the shareholder in his assessment."<sup>1</sup> In 1965, the U.K. joined this list.<sup>2</sup>

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1. Taxation and Foreign Investment - A study by the National Council of Applied Economic Research, (1958), p. 41.

2. Further see Appendix 2.

For the assessment year 1959/60 i.e. immediately before the introduction of the new scheme, every domestic company in India was subjected to a refundable income-tax of 31.5% (income-tax 30% plus surcharge on income-tax at 5%) and a non-refundable super-tax of 20% (normal rate). In addition to the above income-tax and super-tax, companies were subjected to an excess dividends tax and a wealth tax.

Most of the drawbacks of the with-holding device as adopted in India, were fully brought to light by the Taxation Enquiry Commission 1953-54. The Government, it seems, came to appreciate fully the administrative burden connected with this system by amending provisions regarding grossing up of dividends in the hands of shareholders in 1956, so as to avoid the major loopholes of the system and to see that in no case credit allowed to the shareholders exceeded the actual amount of income-tax collected from companies. Unreasonableness of a wealth tax and an excess dividends tax on companies also was realised. In 1960, the new scheme of taxation of companies was introduced and the legal fiction that the income-tax paid by a company was deemed to be paid on behalf of its shareholders was abolished. The wealth-tax and excess dividends tax on companies were withdrawn.

The rates of income-tax and super-tax were fixed at 20% and 25% (normal rate) respectively. This basic rate of tax on companies was fixed at 40 per cent (as against 51.5%) to produce the same amount of annual net revenue as before under the old scheme (especially, in the assessment year 1957/58 and 1958/59) and it was expected that the interests of shareholders would not be affected by the withdrawal of 'grossing-up' benefit.

10. It was often recommended that the tax on companies should not be divided into income-tax and super-tax as it should be defined as 'corporation tax'.<sup>1</sup> In 1965, as a part of general reform, super-tax on companies was integrated with income-tax but it was not named 'corporation tax'. The tax on companies under the new scheme should, in proper, be defined as corporation tax according to the Indian Constitution (Article 366(6)) and the name 'corporation tax' would serve to bring out fully the nature and purpose of the tax.

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1. For example: The Taxation Enquiry Commission, 1953-54, Vol. II, p. 150.