NEW COMPANY TAX SCHEME HITS SHAREHOLDERS

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> "People must come to accept private enterprise not as a necessary evil, but as an affirmative good."
>
> EUGENE BLACK
> *President,* World Bank

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by

Prof. Russi Jal Taraporevala

THE most important change made in the Indian fiscal structure in 1959 was the radical streamlining of the scheme of company taxation, as proposed in the Budget of the Government of India introduced in February **1959** and incorporated in the Finance Act, **1959.** Very substantial alterations are to be made in the scheme of direct taxation of companies, in order to maintain the gross revenues of the Government and yet simplify the working and administration of company taxation. A proper assessment of the impact of the new scheme of company taxation can be made by first comparing it with the previous scheme.

Under the old system, companies were subject to seven different types of direct taxes. There were four recurrent taxes which they had to pay annually—income tax, corporation tax, excess dividends tax and wealth tax. First, companies had to pay income tax at the rate of **30** percent plus **1.5** percent surcharge, making a total of **31.5** percent of their assessed annual profits. The income tax paid by companies was refundable to the shareholders. When companies declared dividends out of their taxed profits, the shareholders received credit in their personal income tax assessments for the income tax paid by the companies—this was known as the process of "grossing" of dividends.

Second, companies paid a non-refundable super-tax at the rate of 20 percent of their annual assessed profits. This was known as corporation tax. Third, companies paid the *so called* excess dividends tax. Dividends paid by companies amounting to between **6** percent and **10** percent of their paid-up capital were taxed at the rate of 10 percent, dividends between 10 percent and 18 percent of the paid-up capital at the rate of 20 percent, and dividends over 18 percent of the paid-up capital at the rate of **30** percent. Fourth, companies had to pay wealth tax at the rate of ½ percent of their net wealth in excess of Rs. 5 lakhs.

In addition to the four recurrent taxes, companies were subject to three special or "penal" taxes—the capital gains tax, the penal super-tax for non-distribution of profits under Section 23A of the Indian Income Tax Act, and the bonus issue tax. These taxes were payable only under certain circumstances. Their details are discussed later, especially since the Finance Act, 1959, includes only minor or marginal changes in these taxes.

The old scheme of company taxation highlighted certain severe administrative drawbacks connected with the process of grossing of dividends. If the dividen'ds had been grossed at the full rate of income tax' applicable to companies, there would have been no difficulties; if the rate of company income tax was 31.5 percent, every Rs. 100 paid as tax-free dividends would have entitled the shareholders to credit in their personal tax assessments of Rs. **46.** Unfortunately, under the old scheme of taxation, the dividends were not always grossed at the full rate of company income tax. The rate of grossing depended on the effective rate at which the companies' profits were initially subject to tax **and** that was often slightly below the full rate. The effective rate of tax depended on the composition of the

companies' income—that is. the proportion of profits subjected to tax as compared with the profits exempt from tax. Thus, some companies had income from agriculture which was not subject to Central income tax, or they had income from tax-free securities which made the rate of grossing of their dividends fall below the full rate. Further. where dividends were paid out of reserves accumulated from past profits, the effective rate of tax depended on the rates of tax at which profits were tnued in the past.

Ascertaining the effective rate of tax on the basis of which dividends were grossed involved extremely complicated. cumbersome and elaborate calculations, which were often beyond the grasp of individual shareholders or assessees. It involved the tax administration in a tremendous amount of paper work, calculations, red tape and supervision. Moreover, until the assessments of various companies were completed, the effective rates of tax applicable for grossing up their respective dividends could not be ascertained. This correspondingly delayed the completion of the assessments of the shareholders. There can be no doubt that under the old scheme of company taxation. the process of grossing of dividends was extremely complicated. It was so difficult to administer promptly and efficiently that the need for reform was obvious.

The new scheme of company taxation proposed in the last Budget. and introduced by the Finance Act, 1959, attempts to eliminate the administrative complications caused by the previous system of grossing of dividends. Indeed, the entire procedure for grossing has been abolished in the case of dividends declared for accounting years ended after 31st March, 1959. Hereafter, it is proposed to levy income tax and corporation tax on companies at rates which

will be prescribed in the annual Budgets. But shareholders will not get any refunds or credits for tax purposes on the income tax paid by the companies on their annual profits. Shareholders will lose the benefits of grossing in relation to dividends declared for the accounting years ended after 31st March, 1959, even if the dividends are paid out of past accumulated profits or reserves. On the other hand, the excess dividends tax and the wealth tax on companies have been abolished and the total rate of income tax and corporation tax is to be reduced.

The rates of income tax and corporation tax applicable to companies under the new scheme will be fixed in the coming Budget. But the rates of these taxes for the purpose of advance payment of tax under Section 18A of the Indian Income Tax Act for the accounting year 1959-60 have been prescribed. The rate of income tax has been fixed at 20 percent of the annual assessed profits. The rate of corporation tax has been fixed at 25 percent of the annual assessed profits. For the present analysis, it is assumed that these rates of tax which have been prescribed for advance payment of tax will be the actual rates of tax payable under the new scheme of company taxation.

Thus, under the new scheme of company taxation, the provisions and statutes applicable to companies have been totally divorced from the taxation of shareholders of the various companies. It has been provided that before companies can declare dividends to their shareholders under the new scheme, they must deduct tax from the dividends at the prescribed rates—which are 30 percent in the case of individual shareholders and 45 percent in the case of corporate or institutional shareholders. Such tax deducted at source on dividends paid will naturally be credited to the shareholders in their tax assessments.

The new scheme of company taxation should be welcomed in principle. It represents a long overdue step towards simplifying and rationalising a highly chaotic structure of company taxation. The abolition of grossing of dividends is likely considerably to simplify and speed up the working and administration of direct taxation of both companies and individuals. The abolition of the excess dividends tax and the wealth tax is a bold step in the right direction. These were unjustified levies which hit companies arbitrarily, inequitably and harshly. They had been widely, almost universally, condemned in principle. Their abolition will make the tax structure more equitable.

The main criticism of the new scheme of company taxation relates to the proposed rates of tax. It has been claimed by many that the burden of tax on companies and their shareholders will increase. On the other hand, the Government has categorically declared that its intention is only to maintain its total revenues and not to increase it as a result of the changes in the scheme of company taxation, so that there will be no additional tax burden involved. Unfortunately, a detailed statistical break-down of the taxes paid by companies in the past is not available. As such, it is impossible conclusively and accurately to assess the exact impact of the new scheme. Yet, various calculations seem to show that it will involve a definite increase in the overall burden of tax on companies.

The broad impact of the scheme can be gauged by comparing the flat, non-refundable total rate of income tax and corporation tax of 45 percent of the assessed annual profits of companies (with deduction of tax at source on dividends at the rate of 30 percent for individual shareholders) with the previous scheme consisting of refunda-

ble income tax at the rate of 31.5 percent of the assessed annual profits of companies, a non-refundable corporation tax of 20 percent of the annual assessed profits, the excess dividends tax and the wealth tax. The change in the burden of tax as a result of the provisions of the Finance Act, 1959, will vary from company to company, depending upon its capital structure and reserves, its earning power and its dividend distribution policies.

But four generalisations can be made. First, companies earning high rates of profits in relation to their paid-up capital will be affected less adversely by the new scheme (or may in some rare cases even benefit slightly) than companies earning lower rates of profits on their paid-up capital. Second, companies distributing a smaller proportion of their annual profits as dividends will be affected less adversely (or in a few cases may even benefit) as compared with companies distributing a larger proportion of their annual profits. These two general propositions follow from the abolition of the excess dividends tax. Third, companies which did not pay wealth tax as they were exempted from it—like banks, shipping companies and insurance companies —will be adversely affected. Finally, companies which had large reserves in relation to their paid-up capital will be affected less adversely (and in a few cases may even benefit) than companies with no reserves or small reserves. This follows from the abolition of the wealth tax.

The table on page 8 shows calculations made on the assumption that companies distributed their entire after-tax profits as dividends and that dividends were grossed up under the old scheme at the full rate. At one extreme, there are companies which under the old scheme paid the least rate of tax. They paid no excess dividends tax and were exempt from the wealth tax. Table A shows that

such companies will be affected most adversely by the new scheme of taxation; their total tax burden will increase by **19.4** percent, their net dividend will be reduced by **20.6** percent, and their gross dividend will be reduced by **22.3** percent as compared with the previous levels.

On average, it may be assumed that in the past the total burden of the excess dividends tax and the wealth tax amounted to **5** percent of the annual gross profits of companies. Table **A** shows that even the "average" companies covered by this assumption will be adversely affected by the new scheme of taxation. Their total tax burden will increase by 8.8 percent, their net dividend will decline by **11.5** percent, and their gross dividend will decline by **13.4** percent as compared with the previous levels.

At the other extreme, it can be assumed that there are a few companies which paid a very high proportion of their annual profits, assumed at **10** percent, by way of the excess dividends tax and the wealth tax in the past. Table **A** shows that such companies will hardly be affected by the new scheme of taxation. Their total tax and their net dividend will remain unchanged, while their gross dividend will be reduced by only **2.1** percent. But it must be stressed that such companies will be in a very small minority. Beyond this, the new scheme of taxation will benefit those rare companies which in the past paid more than **10** percent of their annual gross profits as excess dividends tax and wealth tax.

On average, it appears that the new scheme and rates will impose a heavier burden of tax, and will reduce the dividends paid by companies to their shareholders. *Of* course, the above calculations are based on the assumption that the entire after-tax profits are distributed and that

TABLE

STATISTICAL COMPARISON OF TOTAL TAXES, NET DIVIDENDS AND GROSS DIVIDENDS OF COMPANIES UNDER THE NEW SCHEME OF TAXATION AND UNDER THE OLD SCHEME OF TAXATION FOR COMPANIES DISTRIBUTING ALL THEIR AFTER-TAX PROFITS AS DIVIDENDS.

Types of Total tax / Items	New Scheme of Taxation		Old Scheme of Taxation					
	All types of companies		Companies not paying excess dividends tax and wealth tax		"Average" companies paying excess dividends tax and wealth tax equal to 5% of their G.P.		Companies paying excess dividends tax and wealth tax equal to 10 percent of their gross profits	
	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.
Annual gross profits before tax		100.00		100.00		100.00		100.00
Income tax	20.00		31.50		31.50		31.50	
Corporation tax	25.00		20.00		20.00		20.00	
Excess dividends tax and wealth tax (assumed)	nil		nil		5.00		10.00	
Tax deducted at source on dividends	16.50		nil		nil		nil	
Total tax		61.50		51.50		56.50		61.50
Net cash dividend		38.50		48.50		43.50		38.50
Gross dividend		55.00		70.81		63.51		56.21
Percentage change in the total tax paid by companies as a result of the introduction of the new scheme of taxation			+19.4%		+8.8%		nil	
Percentage change in the net cash dividend paid by companies as a result of the introduction of the new scheme of taxation			–20.6%		–11.5%		nil	
Percentage change in the gross dividend as a result of the introduction of the new scheme of taxation			–22.3%		–13.4%		–2.1%	

dividends in the past were grossed up at the full rate. To the extent that these assumptions do not apply fully in practice, the adverse effects of the new scheme of company taxation will be mitigated. The higher the percentage of gross profits ploughed back to reserves and the lower the past rate of grossing of dividends as compared with the full rate, the less will be the increase in the burden of tax.

Various attempts have been made to compare the net increase in the burden of tax resulting from the new scheme of company taxation on the basis of the different figures published about companies. Thus, other writers on taxation have tried to use the figures published by the Reserve Bank of .India for 1,001 selected companies and the Central Board of Revenue's All-India Revenue Statistics. These calculations seem to show that the new scheme will increase the tax burden; but they are open to the criticism that they are based on published figures which are either not comprehensive enough to cover the entire corporate sector or do not break down the figures sufficiently to allow accurate tax calculations. On a very approximate basis, it can be estimated that the new scheme will probably raise the tax burden by at least 8 percent, and more likely around 10 percent over the previous level.

Some detailed implications of the new scheme of company taxation can now be analysed. The Finance Act, 1959, has a specific provision to protect the interests of holders of ***tax-free*** preference shares. It has been provided that the companies must pay on these shares the same cash dividend as has been paid hitherto. Thus, the companies will have to pay the tax deductible at source for the dividends on tax-free preference shares. As a result, companies having 5%percent tax-free preference shares will have to declare a 7.85 percent taxable dividend on them; companies with

6 percent tax-free preference shares must pay a 8.57 percent taxable dividend; companies having 6½ percent tax-free preference shares must pay a 9.28 percent taxable dividend; and companies having 7 percent tax-free preference shares must pay a 10 percent taxable dividend. In spite of these provisions, holders of preference shares will stand to lose slightly. Under the old scheme, the recipient of a Rs. 100 tax-free preference dividend got a tax credit of Rs. 46 if the dividend was grossed at the full rate, so that the total gross dividend was Rs. 146. Under the new scheme, the recipient of a Rs. 100 net preference dividend will get credit for only Rs. 43 as tax deducted at source, so that the total gross dividend will be Rs. 143, or 2.1 percent less than that received under the old scheme.

Nevertheless, the worst sufferers will be the ordinary shareholders, because in effect the burden of the benefit of grossing dividends which preference shareholders used to get previously at the cost of the Government's revenues has been shifted under the new scheme to the companies. The companies have to pay so much more as preference dividends out of the residual profits available after payment of tax, thus leaving less for distribution to ordinary shareholders as dividends. This change will upset substantially the gearing ratios in the capital structure of various companies. It will make the cost of preference share capital finance to the companies and their ordinary shareholders much higher than under the old scheme.

The new scheme of taxation will involve a substantially higher tax burden on inter-corporate investments. Partial rebates and even full exemption from corporation tax have been available to companies on dividends received by them from shares held as investments in other companies. Thus, a rebate of half the basic rate of corporation tax was given

on dividends received by companies from their Indian subsidiary companies. Under Section 56A of the Indian Income Tax Act, dividends received by companies from other companies were totally exempt from corporation tax if the paying companies were engaged in certain specified industries covered by the Industries Development and Regulation Act. Although these provisions concerning corporation tax will continue under the new scheme of company taxation, the abolition of grossing of dividends will sharply raise the burden of tax for inter-corporate investments. It will reduce the dividends received and retained after tax by companies and their shareholders from inter-corporate shareholdings.

Working on the assumption that companies distributed all their profits after tax and the dividends were grossed previously at the full rate, it can be shown that as a result of the new scheme an individual shareholder will suffer a loss of around 30 percent of his gross dividend income consisting of the dividends he gets from a company holding shares in Indian subsidiary companies not covered by Section S6A of the Indian Income Tax Act. An individual shareholder will suffer a loss in his gross dividend income of as much as around 32 percent in relation to the dividends he gets from a company holding shares in other companies covered by Section 56A of the Indian Income Tax Act. An individual shareholder will suffer a loss of around 35 percent of his gross dividend income in relation to the dividends he gets from a company holding shares in other companies which are neither Indian subsidiary companies nor covered by Section 56A. These figures assume full distribution of gross profits by the companies and grossing of dividends in the past at the full rate.

The increase in the burden of the tax and the reduction

in dividends will be less in direct proportion to the percentage of profits ploughed back by companies into reserves and the extent to which the profits were grossed up in the past at less than the full rate. Nevertheless, there can be little doubt that the new scheme of company taxation will adversely affect dividends on inter-corporate investments. On average, it can be estimated that the new scheme of taxation will in practice increase the burden of tax by around 20 percent over the previous level on inter-corporate investments.

Under the new scheme of company taxation, shareholders will lose the benefit of grossing of dividends even if they are paid out of past profits or reserves. It can be estimated that on 31st March, 1959, the total reserves of companies were at least Rs. 500 crores. Even assuming that the average rate of income tax borne by them over the past so many years was 20 percent, the amount lying to the credit of shareholders in relation to their reserves of Rs. 500 crores would be around Rs. 125 crores. Under the new scheme of company taxation, this sum will be lost to shareholders. In principle, it is wrong arbitrarily to confiscate this amount belonging to shareholders and lying with the Government. However, if the new scheme of taxation is to be effectively implemented, it is unlikely that the old procedure of grossing of dividends can be continued for dividends paid out of reserves.

But there is a very good case for giving some *ad hoc* relief in future for such dividends. One suggestion is to provide that companies would not deduct tax at source on dividends declared from reserves, and they would be deemed to have paid the tax to be deducted at source to the Government. Shareholders would get credit for the amount thus deemed to have been paid as tax deducted at

source (even though in fact the companies would not pay it). Such provisions, which would be similar to the provisions applicable to preference share dividends under the new scheme of taxation, would give a fair and substantial relief for dividends paid out of reserves and would not disrupt the working of the new scheme of company taxation.

The Finance Act, 1959, has introduced marginal changes in the three special or "penalty" taxes payable by companies. First, under the old scheme of taxation, companies were required to pay tax at the rate of 31.5 percent on all capital gains made by them. The new Finance Act has reduced the rate of tax payable by companies on their capital gains to 30 percent. This is a very minor, almost insignificant, relief.

Second, under the provisions of Section 23A of the Indian Income Tax Act, a penal super-tax was imposed on private companies and closely controlled public companies if they did not distribute the minimum statutory percentages of profits. The rate of tax was 37 percent of the entire undistributed profits in the case of industrial companies, and 50 percent of the undistributed profits in the case of investment companies. Thus, the tax was so harsh that it forced companies to distribute the statutory percentages of their profits. The tax became payable if the companies failed to distribute at least 45 percent of their industrial profits and 60 percent of ,their non-industrial profits remaining after tax. Under the Finance Act, 1959, these statutory percentages have been raised to 50 percent and 65 percent, respectively. The Government considers the change necessary so as to ensure that the profits retained by companies covered by Section 23A after the introduction of the new scheme of taxation, without being subject to the penal super-tax, remain at the same level as under the old

scheme. The change introduced by the Finance Act, 1959, in the statutory percentages of profits to be distributed in order to conform to the provisions of Section 23A of the Indian Income Tax Act (and so as not to pay the penal tax under the Section) is not very substantial in quantum. But it must be criticised severely in terms of the extremely undesirable economic effects of the provisions of Section 23A which have been stressed in the past by official bodies, eminent economists, the National Council of Applied Economic Research and Professor Nicholas Kaldor. The provisions of this Section severely retard the growth of many companies by not allowing them to plough back a larger proportion of their profits. They impede the industrial growth and progress of the country. Under the circumstances, the provisions of the Finance Act, 1959, aimed at maintaining the *status quo* concerning the net impact of Section 23A are to be deplored. At a time when the entire scheme of company taxation was being revised, it was especially necessary either to abolish the provisions of Section 23A or at least to make them less harsh. This the Government has regrettably failed to do.

Perhaps the most deplorable step in the reform of company taxation was the change introduced for the bonus issue tax in the last Central Budget. In the past, companies had to pay penal super-tax at the rate of 30 percent of the face value of the bonus shares issued by them. However, bonus shares issued out of premiums received in cash on shares in the past were exempt from the bonus tax. The Finance Minister has now proposed withdrawing this exemption when the new scheme of company taxation comes into force This will increase the burden of the bonus issue tax. Moreover, the taxation of bonus shares issued out of premium money paid by shareholders is tantamount to a straight capital levy on

cash amounts contributed in effect as capital payments by shareholders. The continuation of the bonus issue tax, and the abolition of the exemption in favour of bonus issues made from share premium accounts, is a retrograde step. Even under the old scheme, there was no economic justification for the bonus issue tax. Its inequitable nature and its undesirable economic effects on the capital structure of companies have often been pointed out. The tax has been condemned by many, including the Indian Taxation Enquiry Commission, the Royal Commission on the Taxation of Profits and Income of Britain, the National Council of Applied. Economic Research and Professor Nicholas Kaldor. Thus, there is a strong body of expert opinion which opposes it.

In the past, the bonus issue tax was justified by the Government as being necessary to prevent companies from evading the excess dividends tax by increasing their paid-up capital through the capitalisation of their reserves by issuing bonus shares—and even this was shown to be only a lame excuse for continuing the tax. However, since under the new scheme of company taxation the excess dividends tax is to he abolished, even this justification for the bonus issue tax has vanished. Indeed, the tax now lacks the slightest possible rationale. It will arbitrarily and inequitably discourage companies from making their capital structure more realistic by reflecting the true value of the capital invested in the business, as could be done by capitalising the ploughed back profits or reserves and issuing bonus shares. Further, with the abolition of the excess dividends tax, the issue of bonus shares has ceased to offer any short-term tax advantages. Hence, under the new scheme of taxation, the continuation of the bonus issue tax at the present high rate is unlikely to bring any substantial revenue to the Government because the companies will just not

issue bonus shares. Under these circumstances, it is to be hoped that the Government will abolish the bonus issue tax soon. This is essential for any long-range effort to rationalise the structure of company taxation.

The Finance Minister deserves to be congratulated for making the first bold effort to rationalise and simplify the scheme of company taxation. If the intention of the Government is to maintain its revenue from company taxation, the total rate of income tax and corporation tax under the new scheme should be fixed at a figure between 35 percent and 40 percent of the annual gross profits of companies. Special ad *hoc* relief or concessions should be granted for dividends paid out of past taxed profits which have been ploughed back by the companies as reserves. Some concessions may also be granted for inter-corporate investments, the dividends of which will be severely affected by the present provisions. The provisions of Section 23A of the Indian Income Tax Act and the bonus issue tax should be abolished. Ultimately only one non-refundable tax on the gross profits of companies should be charged at a flat and reasonable rate. This should be the goal of the Finance Minister in his attempt to simplify and improve the scheme of company taxation. It may not be unrealistic to hope that the goal could probably be achieved if Mr. Morarji Desai continues to guide the policies of the Central Finance Ministry.

The views expressed in this booklet do not necessarily represent the views of the Forum of Free Enterprise.

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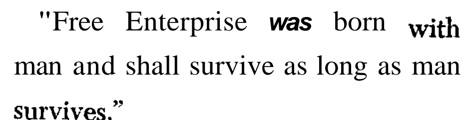

"Free Enterprise *was* born with man and shall survive as long as man survives."

— A. D. SHROFF

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