A REVIEW OF THE FINANCE (No. 2) BILL, 1962

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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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N. A. Palkhivala*

THE most blatantly unjust proposal in the Finance (No. 2) Bill, 1962, and the one most indefensible by any process of reasoning or by reference to any notion of fairplay in a socialistic or welfare State, is the one relating to capital gains and capital losses. If the implications of the Bill are carefully analysed, it would be clear beyond doubt that the proposal has the astounding result of putting the thrifty citizen who helps the progress and growth of the nation by saving and investing, in a worse position in many respects than the gambler and the speculator.

Capital gains tax was charged for the first time in India by the insertion of Section 12-B in 1947 in the Indian Income-tax Act, 1922. The scheme was simple. Capital gains were changed at a rate lower than the aggregate of income-tax and super-tax on ordinary income. Capital losses could be set off only against capital gains and any unabsorbed capital loss could be carried forward and set off against capital gains of a subsequent year, the right of carry-forward being available for eight years. The levy of capital gains tax was virtually abolished by the Finance Act, 1949. It was revived with effect from the assessment year 1957-58 and the scheme of set-off and carry-forward of capital losses remained the same as before.

In the Income-tax Act, 1961, the plan of capital gains tax and set-off and carry-forward of capital losses, as it obtained under the 1922 Act, was xetained.

The Finance Bill proposes to introduce,

usual rates applicable to business profits; while other capital gains which may, to avoid circumlocution, be called "long-term" capital gains, will bear tax at the maximum rate of 25% in the case of individuals and **30%** in the case of limited companies. Secondly, losses arising on the sale of long-term capital assets will not be allowed to be carried forward.

Let us first consider the case of short-term capital assets. The proposed provisions regarding profits and losses on the sale of short-term capital assets have, for the tax-payer, all the burdens of assessments on ordinary business income without the corresponding advantages. Business income bears income-tax and super-tax at the ordinary rates and the same burden is now proposed to be borne by short-term capital gains. But when it comes to the treatment of losses, the businessman is treated much more favourably than the *bona fide* investor:—

(a) Mr. Speculator who buys and sells shares or commodities without taking or giving delivery, is not allowed to set off his speculative losses against his non-speculative income, but he is allowed to carry forward his speculative losses for eight years and set them off against any speculative gains of a subsequent year.

(b) Mr. Trader who does a regular business of buying and selling shares or commodities but takes or gives delivery is allowed to set off his business losses against income under any other head whatever of the same year, and he is allowed to carry forward unabsorbed losses for eight years and set them off against income from any business whatever of a subsequent year.

(c) Mr. Investor who saves what he can and makes a *bona fide* capital investment of his saving but is constrained to sell off the investment within one year at a loss on account of any pressing necessity is allowed to set off the loss against gains arising from any long term or short-term capital assets, but the unabsorbed capital loss can be carried forward for eight years and set off only against short-term capital gains, and not even long-term capital gains,-of a subsequent year.

Thus the capital losses of a *bona fide* investor are given a fiscal treatment more unfavourable than that given to the losses of a speculator or a trader.

Surely, justice demands that if short-term capital gains are to be assessed as ordinary business income, short-term capital losses should be treated in the same way as ordinary business losses and should be allowed to be set off-against other business income or non-business income of the same year or any business income or capital gains of a subsequent year. The only justification for not allowing capital losses to be set off against other income was that capital gains bore tax at a lower rate than other income. But once the difference in rate of tax is abolished and short-term capital gains are assessed at the same rate as ordinary business income, it is most inequitable to deny to short-term capital losses the facilities for set-off which are available to other business losses.

Turning to the position regarding long-term capital losses, it is even worse. Long-term capital losses can be set off only against capital gains arising from the sale of long-term capital assets and not even against the gains arising from the sale of short-term capital assets. Any unabsorbed long-term capital losses are not to be carried forward at all to any subsequent year in any case whatever. Even the long-term capital losses of past years in respect of which a right has already accrued to and vested in an assessee to carry the losses forward, are to become dead losses and are to be completely ignored for the assessment year **1962-63** and subsequent years.

A little thinking would convince any unbiased mind that there is no reason to commend, and every reason to condemn, the abolition of the right to carry forward long-term capital losses. The result of transactions relating to long-term capital assets can be fairly viewed only over a period of time and the assessee should be made to suffer tax only on the net gains arising over a period, to enable him to recoup the

lost capital. The salutary principle that by carrying forward capital losses a genuine investor is allowed to recoup his lost capital would be violated by the proposed changes in the law.

Here again, it is most instructive to note what strident injustice underlies the Budget proposals:

(*a*) Mr. Speculator can carry forward his speculative losses for eight years and set them off against speculative profits of a subsequent year.

(*b*) Mr. Trader can carry forward his trading losses, which may have arisen purely as a result of gambling on fluctuations in the market, for a period of eight years and set off such losses against profits of any business whatever of a subsequent pear.

(c) Mr. Investor who lays by his capital for the longterm development of the country, is not allowed to carry forward his capital losses at all.

The proposals would be truly ridiculous, if they were not so tragic in their operation on the most deserving section of the public. It needs no elaborate argument to demonstrate that the man who deserves to be treated most fairly at the hands of the State is the man who saves and invests, because by saving and investment alone can this economically benighted nation march forward to the broad, sunny up-lands; and yet it is the long-term investor, the backbone of a stable and progressive nation, who is sought to be treated most harshly in the latest Finance Bill. He alone is sought to be denied the right to carry forward his losses—a right which is availabie to *(i)* the gambler who gambles on fluctuations on the Exchange, (ii) the speculator who buys and sells without ever taking, or intending to take, delivery, and (*iii*) the short-term investor who does not hold his capital assets for more than a gear.

The only plausible argument which can possibly be urged in support of the Government's proposal to abolish the right to carry forward long-term capital losses is that some

assessees have been known to claim bogus capital losses with a view to carrying them forward to a subsequent year in which they make capital gains, This argument is easily met by three cogent answers:

(1) In cases where capital assets are sold with the object of avoidance or redaction of the liability to capital gains tax, the Department has full power (under Section 52 of the Income-tax Act, 1961) to rewrite the transaction, disallow the capital losses and in fact tax the transferor on the capital gains which he did not make but which he could have made by selling the asset at full market value. This is a complete safeguard for the Revenue.

(2) Claiming bogus capital losses is not something peculiar to long-term capital assets. Such loss can equally be claimed (a) in ordinary business dealings, (b) in speculative dealings, and (c) short-term capital assets. If in the last-mentioned three cases the right of carry-forward of losses is allowed, why should it be denied in the first case which is the most deserving case in a socialistic State, viz., the case of the citizen who saves and makes a long-term investment of his savings?

(3) Assume that a handful of cases arose where the capital losses claimed were suspected to be bogus, would that justify the denial of the right to carry forward capital losses to the entire investing public of India? **A** system of administration under which an entire people is denied its legitimate rights because a few wrong-doers cannot be found out, is not a democracy, it is despotism.

If the Budget proposals are allowed to be passed into law, they would operate most inequitably in all cases of genuine capital losses. A middle-class man who invests his capital in the shares of two Companies which are sold ins different years, would have to pay capital gains tax in one year without taking into account the capital losses of an

earlier year, even though taking the two sales together there was no capital gain at all. A Company making long-term investments and vitally contributing to the economic growth of the country would have to pay capital gains tax without taking into account capital losses of even the immediately preceding year, although on the whole there may be a capital loss, taking the results of the two consecutive pears together.

Under the Income-tax Act, 1961, capital gains tax is sought to be charged for the first time even when any capital gains are made on the liquidation of a Company or on the amalgamation of two Companies. It would be most unfair that a long-term investor who suffers loss on the liquidation of a Company in one year and makes a profit on the liquidation of another Company or the amalgamation of two Companies in the next year, should have to pay tax on the capital gains without being able to set off the capital losses of the earlier year.

Again, a Company which is itself in liquidation may have to sell its assets over a period of two or more years in the course of liquidation proceedings, and it would be equally unfair to such a Company in liquidation that it should have to pay capital gains tax on its capital profits without the right to set off the carried-fonvard capital loss of earlier years.

If an assessee has incurred a loss on the sale of a long-term capital asset, he might be forced to sell other long-term capital assets which have appreciated, merely with a view to ensuring that the benefit of set-off of capital loss on the first-mentioned sale is not lost. Such a forced sale would be detrimental to the nation's economy and harmful to the investor's interest, since it would deprive him of the chance to retain the good asset till it has appreciated further in value.

What has been said above should be enough to indicate that the proposed abolition of the right to carry forward long-term capital losses is a truly retrograde step. It would act as a disincentive to save and invest, and would adversely affect investments in the corporate sector. There are Companies which make trade investments, i.e., investments made

in other Companies for the purpose of helping the investor's own business. Secondly, there are Companies which have invested substantial part of their own funds in subsidiaries. Thirdly, there are Companies which promote the industrial development of the country by giving long-term finances to, and subscribing to the share capital of, new concerns. All these types of corporate investments would suffer a major set-back if long-term capital losses are not allowed to be carried forward. If the Government is anxious to promote the growth of equity habit in the country and to ensure that equity holdings become broad-based, it is vitally important that private investors as well as financial institutions, who contribute significantly to the realisation of this objective, should not be penalised by the denial of the right to carry forward capital losses. Whether you believe in socialism or whether you believe in basic principles of justice and fair-play, you cannot but agree that the proposal to abolish the right to carry forward long-term capital losses must be scrapped before it becomes a blot on the Statute Book of India.

Time and again it has been pointed out, not only by independent economic thinkers but by Commissions and Committees appointed by the Government, that the limits of direct taxation had been reached. But the limits are still proposed to be raised to more vertiginous heights by the new Budget. The less than one million people in India who pay income-tax will have to bear an additional burden which will impair further their ability to save and invest.

The increase in corporate taxation may be considered in four aspects. First, the rate of corporate taxation is sought to be increased from 45 to 50 per cent. Today, when the shareholder gets no credit whatever for the tax paid by the company, any increase in corporate taxation would augment the burden on the investor, which is already top-heavy. Rut there are other directions in which the proposed increase in corporate taxation would result in unjust consequences. For instance, the Tariff Commission has, from time to time, recommended certain prices for basic industries, like steel, coal, cement, paper, sugar and chemicals, where the Tariff Commission has

provided for a 12 % gross return, taking into account the tax burden at 45% on the profits. If, now the rate of corporate taxation is sought to be increased to 50%, the net margin of profits left with the manufacturer would be less than what was contemplated as fair by the Tariff Commission. To take a less important piece of legislation, the Preference Shares (Regulation of Dividends) Act, 1960, provided for an increase of 11% in taxable preference dividends on the basis that income-tax on company, for which the shareholder no longer gets credit, is 20%. If, now, income-tax on companies is sought to be increased to 50%, it would mean that the preference dividends should really be increased by a higher figure than 11%. In a country like ours where we have new legislation in a flood, it is most essential that laws should be stable and comprehensively planned, to avoid dislocation on different fronts. The chronic tinkering with the rates of corporate taxation is a good illustration of how injustices are caused by different laws acting and reacting upon one another and one of the laws being changed without regard to the reactions in different fields.

Secondly, the Budget still proposes to levy tax on dividends received by one limited company from another limited company at the rate of 35% as against 40% last year. If B.Ltd. holds shares in A.Ltd. and C.Ltd. holds shares in B.Ltd., A.Ltd. pays full tax on its profits, B.Ltd. again pays full tax on the dividend income from A.Ltd., C.Ltd. again pays full tax on the dividends received from B.Ltd., and the shareholder of C.Ltd. again pays full tax on his dividend income without my credit for the taxes paid by any of the three limited companies. Thus, where there are corporate shareholders, the same profits in their passage from the first company to the shareholder of the third or fourth company, suffer tax at a number of points. This is most unfair. Whatever may be the justification for assessing an individual shareholder over and above assessing the limited company, where the shareholder is itself a limited company, there should be no tax on its dividend income. To levy income-tax twice is bad enough, but to levy it three, four and five times is oppression. In the United Kingdom, a limited company pays neither income-tax not super-tax on its dividend income. In the United States, only about 15% of the dividend income suffers

tax in the hands of a corporate shareholder. But in India the entire dividend suffers tax in the hands of the corporate shareholder. This is a crying injustice and it should have been remedied long ago. But while Budget after Budget has made provisions in favour of the State, it is rarely that you find any provision in favour of the citizen, even when an existing injustice cannot be defended on any principle of reasoning or by reference to any felt necessities of the time.

Thirdly, the Budget proposes to hit limited companies by reducing the ceiling of entertainment expenses from Rs. 1,00,000 to Rs. 60,000. The ceiling of Rs. 60,000 may be too much for one company and too little for another. The variety of circumstances in which entertainment expenditure has to be incurred is beyond enumeration. A dishonest company has ways and means of tucking away its entertainment expenditure under other heads. It is the honest company which would suffer as a result of the arbitrary rule of thumb sought to be addopted in the Budget. In this connection, a suggestion made by *The Economist* of London is worthy of very serious consideration. That publication suggested that entertainment expenditure may be required by law to be listed separately (like Directors' fees) on public companies' published accounts. The companies' shareholders could then see how often they (and the tax payer) were paying for their top executives' lunches; any companies in which these expenditures were particularly extravagant would then become the butt for informed criticism — instead of all businesses being the butt for uninformed criticism, as now. This would be a more salutary provision than the arbitrary ceiling on entertainment expenditure irrespective of the *bona fide* business needs of the company.

The fourth aspect of corporate taxation is the incentive for export sought to be held out in the Budget. It is most regrettable that the very well-conceived and well-reasoned suggestions of the Committee headed by Sir Kamaswami Mudaliar for promoting exports should have been still kept in cold storage. The only new incentive offered for export in the Budget is that on the profits made on export, the rate of taxation would be 45% on limited companies as heretofore, and

not the increased rate of 60%. This, in substance, is the effect of the Budget proposal to give a rebate in tax of 10% in respect of export profits. The net result is that the enterprising manufacturer who tries to push his export trade will have to pay exactly the same tax as he paid last year. This is a queer type of incentive. In short, the incentive is that export profits will bear the same burden of tax as they did last year. It is the incentive which an unthinking patent offers to the child who is told that if he studies harder, he would get the same amount of spanking as he used to get before and no more. The contrast between the liberal, in fact extravagant, way in which public revenues are spent by the Government, and the niggardly manner in which relief is sought to be given to citizens by way of incentive, presents a fascinating problem to the student of public affairs.

The rates of taxation on individuals in India are among the highest in the world and they are sought to be now further increased. In the y e . 1960 the highest rate of tax on earned income was 77%, and on unearned income it was 81%. Last year the rate was raised on earned income to 80.5%, and on unearned income to 84%. This year it is sought to be raised to 82% on earned income, and to 87% on unearned income. When you take these rates of income-tax in conjunction with wealth-tax, you realise that the burden is so excessive as to afford no inducement either to work or to save. The National Council of Applied Economic Research recommended recently that the burden of direct taxation should in no case exceed 100%. So far from accepting the recommendation of that research body, the Government has now increased the rates, so that more people will now be paying direct taxes in excess of their total income than last year. If a citizen has a total income of Rs. 70,000 and net wealth of Rs. 2,00,000, he has not only no incentive but a positive disincentive to save and invest. Any further saving invested in any share or other asset yielding a 6% return would result in income-tax and wealth-tax taking away more than 100% of the entire income from such further investment. For instance, from Rs. 6 yield on an additional investment of Rs. 100, the citizen will pay 1 rupee by way of wealth-

tax. Income-tax on Rs. 6 at the rate of 87% would come to more than Rs. 5, and thus wealth-tax and income-tax in the aggregate will amount to more than Rs. 6, which is the total yield on his investment!

In no other country is income-tax levied twice over on the same income in the hands of the same individuals. But in India a registered Partnership has to pay income-tax, and the individual partners have to pay income-tax over again on their shares of profit received as partners. The Law Commission, headed by the Attorney-General of India and consisting of Supreme Court and High Court Judges, Advocate-General and eminent lawyers, strongly recommended that the double tax on Partnership profits should be abolished, since unlike a limited company a Partnership was not a separate legal entity. The Government of India, so far from honouring the recommendation of the Law Commission, has sought to increase the unjust double levy on Partnership profits. The Law Commission had also recommended that Court Fees should be abolished, and the Governments of different States actually increased Court Fees after the Law Commission's Report. This is a most disquieting feature of the way the Central and State Governments function in this country. Not only is public opinion completely ignored but even the unanswerable reasoning and conclusions of high-powered commissions are flouted, unless they happen to coincide fortuitously with the preconceived notions of some individuals in office. More than three centuries ago Bacon said: "Knowledge is power". Democracy reaches its height when knowledge and power are combined in the same individual. Democracy faces its greatest danger when knowledge is possessed by some and power by others.

Mr. Morarji Desai has displayed great courage and independent thinking as the Finance Minister and has proved himself a great democratic leader. His abolition of the Expenditure Tax has shown his keen sense of realism and his courage to do what he thinks is right, regardless of the dictates of abstract ideology. The only hope of the citizen is that the

Finance Minister would rise to the occasion and respond to the appeal of reason and justice and withdraw some of the unsatisfactory features of the Budget proposals.

The views expresssed in this booklet are not necessarily 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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