

# REFORM OF DIRECT TAXES

K.R. RAMAMANI



**FORUM OF FREE ENTERPRISE**

PIRAMAL MANSION, 235 DR. D. N. ROAD,  
BOMBAY 400 001.

“Free Enterprise was born with man  
and shall survive as long as man  
survives.”

— **A. D. Shroff**

1899-1965

Founder-President

Forum of Free Enterprise

# REFORM OF DIRECT TAXES

By  
**K.R. Ramamani**

Justice Oliver Wendell Holmes once said: "I like to pay taxes. With them I buy civilization." Today perhaps only a few may share the sentiments of Justice Holmes. On the contrary, given the high rate of taxation in India, coupled with the decline of civilised life, most of you would probably abhor the payment of taxes. Indeed, ever since Caesar Augustus issued a decree that all the world should be taxed, mankind has suffered the burden of some tax, impost or duty, and has hated it. In the course of man's recorded history, Justice Holmes must perhaps be the only person who liked to pay his taxes!

"But in this world, nothing can be said to be certain, except death and taxes". So said Benjamin Franklin 193 years ago. The statement is still true with the modification that, in the Indian context, it seems to be a certainty that we will continue to have one of the highest rates of taxation in the world. A smaller and still smaller group of people pay higher and still higher taxes. Once this inevitability is recognised, the necessity for thinking on the subject arises.

---

\* This text is based on the A.D. Shroff Memorial Lecture delivered under the auspices of the Madras centre of the Forum of Free Enterprise on 17th November 1982. Mr. Ramamani is an eminent tax counsel.

According to the classic definition of the direct tax given by Mill, "A Direct tax is one which is demanded from the very person who is intended or desired should pay it. Indirect taxes are those which are demanded from one person in the expectation and intention that he shall indemnify himself at the expense of another". Mill; "Political Economy" Book V A.C. for Manitoba vs. A.C. for Canada (1925) AC 561 at 566.

This definition is still substantially valid. A tax on income is, therefore, intended to be paid by an income-earner. The liability is not intended to be passed on to another. There is the question of a recoupment or reimbursement. The income-earner is the best person to know how much he has earned. The levy, assessment and collection of tax depends on correct and proper reporting of income. The tax-payer has to voluntarily fulfil the role of a tax-gatherer. He has "voluntarily" to file the return correctly and in time without waiting to be reminded, pay tax in advance, furnish innumerable statements and forms as an employer, employee, principal officer of the company, contractor. It is, therefore, said that a direct tax, the efficacy of which depends on the honest reporting and compliance of the tax-payer, is a tax on honesty. This aspect is inter-related to the problems of tax evasion and tax avoidance tackled periodically by "voluntary" disclosure schemes.

Is there a need for reform in direct taxation? An examination of this question would involve an analysis of the efficiency of the present taxation system and an appraisal of the gap between the hope and the realities.

The best reform in the present circumstances, it is said, is no reform — Tax amendment holiday. Such inaction would be harmful. It is true that an old tax is a good tax. While new types of taxes, innovations and complications are to be avoided to the extent possible, it is unwise to hold the view that we have reached perfection in taxation policy and matters of tax legislation.

On the hypothesis that there is a need and scope for reform we may examine the present scene and confine ourselves to broad features and important sectors. Corporate taxation, that is tax on the income of corporate bodies, is a vital issue. The present debate is on the justification for reduction of such tax. The basic rate of tax on a company would be between 45% to 65%, exclusive of Surtax in applicable cases. The above rate is applicable on the income computed according to the provisions of the Income Tax law, arrived at after making adjustments to the book profits.

It was recently announced that the analysis of about 20 Public Limited Companies showed that their effective rate of tax was as low as 40%. The conclusion that was sought to be conveyed to the general public was that income-tax rates were not oppressive as they appear to be. But this conclusion is fallacious. The state of the health of the people cannot be judged by the health of the nation's top few athletes. The real question that must be asked is, "How does the average industrialist fare in the existing scheme of taxation,?"

But before we go to that, it must be ascertained as

to how companies having large book profits have paid comparatively little and in some cases, no tax?

Broadly speaking, the explanation can be given as follows: —

The book profit is higher on account of the straight-line method of accounting adopted by these companies while the profits for Income-tax are on the basis of W.D.V. method. In the W.D.V. method, the deduction for depreciation is exponential in the beginning and gradual subsequently. Under the provisions of the Companies Act, the quantum of depreciation may be either at the rates as per the I.T. Act or an amount arrived at dividing 95% of the original cost by the number of years for which the asset can be used, or on any basis approved by the C.G. which has the effect of writing off 95% of the original cost of the asset on the expiry of the working life of the asset.

Thus, the method adopted for computation of depreciation will be different for the purpose of calculating book profits and for income-tax purposes.

From an analysis of a large public limited company, the following figures emerge for the last assessment year which has been finally disposed of — in the sense no case relating to this year is pending at any level.

(All figures in lakhs.)

|  |                |
|--|----------------|
| Take (75-76 to 79-80) Book Profits   | Rs. 6,618      |
| 1. Difference between Book depreciation and I.T. Depreciation for the period 1975-76 to 79-80. |                |
| This represents a drop of 45.11%   | Rs. 2,810      |
| 2. Initial depreciation development rebate Investment allowance for 5 years                    | Rs. 3,007      |
| 3. 80J relief  | Rs. 216        |
| 4. Scientific Research expenditure Export promotion etc.                                       | Rs. 426        |
|  | <hr/>          |
|  | Rs. 6,459      |
|  | <hr/> <hr/>    |
| The taxable income   | Rs. 159 lakhs. |
| Tax at 57.75%  | Rs. 91 lakhs.  |

(Source: a paper presented at a national seminar in Ahmedabad, Feb. 1981)

It is, therefore, fallacious to arrive at and compute the effective rate of taxation on the above basis. There are a few companies who have changed from WDV basis to straight line basis just on the eve of issue of bonus shares or rights shares. Such a course is, however, perfectly legitimate and called for the simple reason that taking an overall view, the figures as per tax code and as per the books will coincide. Eventually, one cannot claim depreciation greater than the original cost. It is only a matter of accelerated adjustments

with subsequent modification setting the matter right in course of time.

Thus when the meaning of "profits" is itself different, depending on several factors, we are cautioned from making sweeping remarks about a lower effective rate of taxation. There are several areas of controversy relating to deductibilities of expenses. The company men treat the expenditure as capital in its books but yet may be justified in claiming it as revenue. The liability may be claimed for I.T. purpose though not charged to accounts for book purposes.

It is seen that Capital allowances like depreciation, Investment Allowance and scientific research expenditure contribute to sizeable relief. The present system of taxation benefits a large company with profits expanding or a new company investing large funds, thereby postponing payment of tax. While this scheme is laudable and is essential, something more is necessary to correct the error of ignoring a large segment of corporate sector.

Many of the concessions in the statute book are illusory. Under Sec. 80I, profits upto 25% of a new industrial undertaking a company is not taxed for the first 8 years. But having regard to the several capital allowances, there should be no sizable profit for the first few years. There is no provision for carryover of the reliefs. The items of deductions listed out under Chapter VIA of the I.T. Act. are permissible only if the assessee makes a profit. hence the bulk of relief is



inoperative, at any rate in the first few years of a company.

In order to attract equity capital, it has been suggested that convertible debentures may be permitted even in the case of a newly established company and not merely in the case of a company which is expanding. The Income Tax relief that has to be considered is the treatment of the interest paid for tax purposes, viz., to allow it as revenue deduction to be carried forward and set off in the year of profit. A borrowal of Rs. 100 envisages an interest at Rs. 12/- while to receive the same amount as dividend, the company has to generate a profit of Rs. 31. This situation arises because of double taxation of the company and shareholder independently without any credit to the shareholder or the company on distribution.

In a paper submitted to Federation of Indian Chamber of Commerce and Industry, it has been pointed out that the treatment of companies below Rs. 1 lakh is inconsistent as compared to the assessment of partnerships. If high rates are moderated in the case of larger companies by exemption and deduction the smaller companies must at least be put at par with partnerships especially when there is an additional tax in the hands of the shareholder.

Certain facts stare us at our face. The enormous amount of litigation, the suspicion on the part of the Department that the assesseees are claiming reliefs without really fulfilling the conditions, the attitude

that the reliefs should be granted only after scrutiny, proof and vociferous claim and not when the assessee has not claimed it by oversight though conditions are satisfied. One is exasperated to say that a straight tax cut coupled with certainty is better than a multiplicity of reliefs sanctioned by mere verbiage of doubtful import. In fact, in the report of second Inter-Regional Seminar on Development Planning held at Amsterdam in September 1976 under the auspices of UN it is mentioned: "Every effort should be made to guard against the placing of heavy tax burden on the more productive sectors of the economy. Not only would unduly high tax reduce incentive to increase the output and motivation but they would also encourage tax evasion. Another experience has been that lower corporate taxation has always resulted in faster rate of economic growth".

One important aspect to be considered is the law relating to the splitting up of corporate bodies. Successful and large companies have developed internal stresses and strains. Consequent to "generation gap" in the shareholding pattern, the board-room which was once a meeting spot of a well-knit family unit has sometimes turned into a camp of warring factions seeking directions from outside bodies. We have tax provisions encouraging amalgamation when they are in public interest. We should have similar provisions for splitting up. At present, the tax provisions relating to capital gains, terminal allowances, dividend gift tax and the like act as a disincentive.

To summarise, the areas for reform to be considered are:

1. Tax relief for large companies to re-organise by way of splitting up into different units.
2. Reduction in rate for smaller companies at least.
3. Restructuring the tax system to encourage investment in equity share by a direct method.
4. Removal of provisions relating to disallowances of managerial remuneration, hotel expenses, guesthouse expenses, interest paid on deposits etc.
5. Removal of restriction in Chapter VIA of the I.T. Act with regard to the relief that the company should make a profit.
6. Additional relief on capital gains on selected capital investments like Plant and Machinery etc.
7. Removal of Compulsory Deposit Scheme.

Today, what is of paramount importance is the economic well-being of our population. To a large extent, the rate at which we lift people above the poverty line will depend not on the rural schemes alone, but on the rate of our industrial growth. The only answer to solving the problem of unemployment, of poverty, is the rapid development of our industrial sector. The success stories of South Korea and Taiwan are ample testimony to this statement. Under the present I.T. code, the odds are heavily against the average company. A pragmatic taxation policy is of immense importance to the attainment of rapid industrial growth. A study of the tax rates of indifferent countries will show that there is a correlation between

economic growth and taxation policies and it will be clear that economic growth and tax rates are inversely proportional.

Francis Bacon once said that a people overlaid with taxes would never become valiant or martial. This statement was made over 600 years ago when military prowess was of paramount virtue. I may paraphrase Bacon and say that a people overlaid with tax would never be prosperous or honest.

*The views expressed in this booklet are not necessarily the views of the Forum of Free Enterprise.*

“People must come to accept private enterprise not as a necessary evil, but as an affirmative good.”

— **Eugene Black**

## Have you joined the Forum?

The Forum of Free Enterprise is a non-political and non-partisan organisation, started in 1956, to educate public opinion in India on free enterprise and its close relationship with the democratic way of life. The Forum seeks to stimulate public thinking on vital economic problems of the day through booklets and leaflets, meetings, essay competitions, and other means as befit a democratic society.

Membership is open to all who agree with the Manifesto of the Forum. Annual membership fee is Rs. 30/- (entrance fee, Rs. 20/-) and Associate Membership fee, Rs. 12/- only (entrance fee, Rs. 8/-). Graduate course students can get our booklets and leaflets by becoming Student Associates on payment of Rs. 5/- only. (No entrance fee).

Write for further particulars (state whether Membership or Student Associateship) to the Secretary, Forum of Free Enterprise, 235, Dr. Dadabhai Naoroji Road, Post Box No. 48-A, Bombay-400 001.

---

Published by M. R. PAI for the Forum of Free Enterprise, "Piramal Mansion", 235 Dr. Dadabhai Naoroji Road, Bombay-1, and printed by U.K. Goshalia at Ruby Printers, 30-D, Cowasji Patel Street, Fort, Bombay-400 023.