CORPORATE TAX REFORM IN INDIA
THE TAX INTEGRATION ISSUE

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Summary

Two kinds of tax differentiation in the present income tax system in respect of corporate source incomes are pointed out: (a) equity incomes *vs* interest incomes, and (b) dividends *vs* retained profits. Various schemes of tax integration are examined. Schemes aiming at integration at the shareholders' level are found cumbersome and past experience in this respect is not encouraging. Among those seeking integration at the companies' level, both the *split rate* system as well as *dividend deduction* system are also not without difficulties. Keeping in view the objective of simplicity, this note favors partial exemption of corporate dividends at the company level. The exemption limit could be prescribed either in absolute terms or as a proportion of profits to net worth. In this way, the tax biases affect coporate source incomes only when they exceed reasonable or `normal' limits.

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1. Introduction.

The question of integrating the corporate and personal income tax systems has remained vexatious for a long time. The non-integrated income tax system has systematically nurtured two kinds of bias over the years: one in favour of debt financing of corporate investment by exempting interest payments from taxable profits, and the other in favour of retained profits by double taxing dividends. To some extent, the ill-effects were countered by credit restrictions and partial exemption of dividends in the hands of shareholders. Yet, government intervention in the flows of funds mechanism of the corporate sector with regulations and counter-regulations may not be conducive for achieving allocation efficiency. Especially, the proposed reductions of section 80L exemptions coupled with clear signs of easing of the credit restrictions under the suggested monetary reforms might aggravate the tax distortions. All this point towards a need for revamping the income tax system with commensurate adjustments.

The objective of this note is to suggest suitable alterations in the income tax system for achieving a reasonable degree of parity in the tax treatment of the three corporate source incomes *viz.*, dividends, interest and capital gains, keeping in view the administrative feasibility and the prevailing levels of tax compliance. The note begins with a brief review of the government policy towards this aspect in the past in section 2 and a recap of the debate on tax integration in section 3. Section 4 examines some of the widely used methods of tax integration in the world and section 5 seeks to choose a tax integration method appropriate for the Indian context. Finally, section 6 dwels into the likely operational difficulties in adopting the alternative methods along with suggestions as to how best to overcome them.

2. The Present Position.

At present, interest payments by companies are exempt from the corporate profits tax under the plea that they are part of business expenditure. Nevertheless, interest incomes are taxed in the hands of bondholders as personal (or business) incomes. Equity returns either in the form of dividends or capital gains, in contrast, are taxed twice - once as corporate profits and again in the hands of shareholders as personal incomes. Further, under the present 'Classical' system, the tax treatment of equity incomes is uneven. Dividends are subject to higher tax rates compared to longterm capital gains arising out of retained profits. Thus corporate source incomes are taxed at differential rates depending upon the channel through which they are realised.

The present tax structure is a result of long evolution. Until the sixties, the system was characterised by attempts at partially integrating the taxes at the two levels - companies and their shareholders, by means of the 'grossing-up' practice. Towards the beginning of the sixties however, the system was switched over to pure Classical type owing to administrative difficulties faced in the grossing-up system. Superimposed on this Classical system were the occasional (excess) dividend taxes that infact accentuated the relative tax burden on dividends.

The resultant distortionary effects became increasingly noticeable over the years. The heavy tax bias against equity incomes *vis a vis* interest incomes on the one hand, and higher taxation of dividends as compared to retained profits on the other hand, meddled with the investors' choice leading to inefficient allocation of funds in the economy. The discriminatory tax policy also curtailed the ability of small and new companies to raise funds and this trend had contributed to the growth of monopolistic forces in the economy. From the mid-seventies on, there have been efforts to soften the tax bias against dividends, probably taking note of the wide-spread dissension. Not only the excess taxes were repealed, but also dividend incomes up to certain limits were exempted in the hands of shareholders. Even these small steps have led to considerable revival of public interest in the equity market.

However, there is need to combine the piecemeal attempts and streamline the tax integràton policy. At this juncture, the policy questions that remain are, (i) whether or not to bring some degree of parity in the taxation of equity incomes *vis a vis* interest incomes, and (ii) whether or not to continue with the efforts of mitigating the double and uneven taxation on equity incomes, and if yes, (iii) whether to continue with the efforts of integration at the shareholders' level, or switch over to company level integration.

3. The Polemics.

The phenomenon of interest income being exempt from corporate income tax follows from the notion that companies are owned and controlled by shareholders, and bondholders are mere suppliers of capital without sharing the risks of incorporation. However, with the widening of the gap between ownership and control in modern corporate form of business, shareholders are also loosing their right to participate in management, and their role is also reduced to mere suppliers of capital on terms less definite than those customarily given or demanded by bondholders. Despite the legal distinction still drawn between a shareholder and a bondholder, economically the positions of the two tend to be the same. In view of this, there is no reason why the same preferential tax treatment is not extended to the shareholders. Also, the unequal tax treatment encourages corporations to rely heavily on debt-financing and retain too great a share of net corporate income leading to distortions in macro-balances.

Yet, the case for full exemption of dividend incomes is also not indisputable. There is no denying the fact that equity holders do stand on a different footing from bond holders. Retained profits, for example, belong to the former rather than to the latter. Considering this, only a portion of dividends may be allowed as tax deductible. Thus while the return paid as a reward for risk-taking need not be tax deductible, there is a case to deduct a portion of return paid to the shareholder as a 'creditor' from corporate income tax in an effort to bring parity with interest payments.

As regards the tax integration between distributed and undistributed profits, the controversy remains unresolved to date. Proponents of tax integration view companies as agents of shareholders and therefore, argue that tax differentiation between distributed and undistributed profits violates the principles of equity as well as affects efficient allocation of resources in the economy. The principle of equity is violated because firstly, tax liabilities of similarly placed shareholders belonging to different companies might not be equal, and secondly, even for the same company, retained profits are taxed at rates different from those applicable to dividend incomes of shareholders in different brackets. The extra tax burden implied by a two-tier tax system on capital income reduces the rates of capital formation and economic growth. These arguments imply that some degree of integration is essential between the company level taxes and taxes on dividends at the individuals' level.

In contrast, supporters of differential tax treatment prefer to view corporations as entities separate from shareholders and thus see no justification for alleviating the double tax burden on dividends. They hold that the conduit view may be more relevent for closely held companies in which the interests of shareholders and those of the firm are closely identified. For the widely held companies, the conduit view is not so relevent, because of a pronounced seperation of ownership and control, and a possible conflict of interests among different groups of shareholders with respect to dividend policy. In fact, some of the supporters of differential taxation went to the extent of characterising the conduit view as no more than `tax theology', about which there need not be an agreement. Also, one of the most popular arguments against integration has been that corporate income tax adds greatly to the overall distributional progessivity of the tax system, and any attempt at integration might reduce the desired degree of tax progressivity.

Also, the seperate entity view questions the importance of the presumed loss of welfare resulting from use of a Classical system. It suggests that a lot of uncertainity surrounds the effects on allocation of resources of the various forms of corporation taxation, and therefore the efficiency argument can hardly be used as a base to support integration. The claim that tax-induced profit retentions lead to inferior investment decisions has also been questioned. On the contrary, it is held that firms that retain more profits can have better access to external capital markets. Further, the effect of corporate taxation on the financial structure is not conclusively established.

By far, the greatest attraction of the separate entity view has been that it helps simplifying the tax administration considerably. The view has an added appeal for governments of developing countries, for, by allowing differential taxation of dividends and retained profits, it affords the much needed flexibility to attune tax policy to the developmental objectives such as stepping up of corporate savings, maintenance of incomes' equality, reduction of conspicuous consumption by shareholders, control of inflation and maintenance of reasonable wage-price stability.

Despite the practical edge of the seperate entity viewpoint, in some of the countries that have adopted non-integrated tax systems there has been a growing awareness of the distortions created and there have been signs of a slow but steady shift in their tax policy towards neutralisation of the tax burden between dividends and retained profits. The concensus view now appears to be that the question of integration should be resolved not so much interms of theoretical logic alone but interms of the overall effects on tax burden, growth, savings, investment and other fiscal and social aspects. In the case of India, the favourable response to even milder attempts to mitigate the double taxation at the shareholders'level shows that some degree of integration is needed.

4. Practices in Other Countries.

A. Tax Integration Methods.

Although the economic distortioncs caused by the uneven taxation of equity incomes *vis a vis* interest incomes has been drawing attention, so far few countries have made any conscious attempts to completely mitigate such differential tax treatment. In contrast, a variety of well-experimented methods are now in vogue for bringing some degree of parity between taxation of divdends and retained profits. It should be noted that some of the methods devised to mitigate tax differentiation between dividends and retained profits also have built-in features that help achieving tax parity between equity income and interest incomes.

The tax integration could be at the company level or at the shareholders' level. At one extreme lies the *Classical system* under which corporate profits, dividends and capital gains are independently treated with no adjustment whatever. Prominent among countries that have adopted this system are, UK (1965-1973), France (before 1965), Australia, Denmark, Luxembourg, Netherlands, Spain and Switzerland. In contrast, double taxation is completely neutralised under the *Full Integration System*. Although not yet practiced in any country, the suggested method of achieving full integration is to allocate corporate profits proportionately to the shareholders to be taxed at the respective marginal personal income tax rates.

In between the two extremes lie various *Partial Integration* schemes where double taxation is mitigated only partially. The partial integration systems can be grouped into two broad categories; (a) those that seek to mitigate double taxation at the company level, and (b) those seeking the mitigation at the shareholders' level.

At the company level, the mitigation of double taxation on dividends can be achieved either by adopting *Primary Dividend System*, or a *Split Rate System*. Under the former, a certain amount of dividends are deducted when corporate profits are assessed for tax. This system is found mostly in the Scandinavian countries. Under the latter system, the rate of corporation tax payable on distributed profits is different from (usually lower than) that payable on retained profits. The system is found in Austria, Finland, Israel, Japan and so on.

At the shareholders' level the partial alleviation of double taxation can be achieved either by *Partial Exemption* of dividend incomes from personal income taxes (US, Portugal), or by adopting some form of *Imputation or Tax Credit System* under which dividend recepients may credit to their before-tax income certain portion of the corporation tax paid by the company on these dividends. Dividends, thus grossed-up by the tax credit, are treated as taxable income, with the tax credit then credited against personal income tax liabilities. There are many variants of the imputation system. For example, in Belgium, tax credits are given even when the company does not pay corporate tax. In Canada, shareholders merely deduct 20 per cent of dividends from their personal income tax liabilities. In Italy, a *Schedular system* is followed. France follows *avoir fiscal* system under which the excess tax credit is refunded to the shareholder.

B. Choice Considerations.

From the point of economic effects, what matters is the decision whether or not to go for tax integration, and if so to what extent. The choice pertaining to the method of integration itself is less relevent as the desired degree of integration can be achieved within almost any method by altering the tax rates or adjusting the tax base structure. Even so, the choice depends on a number of other considerations - behavioural, equity, revenue and administrative convenience.

Behavioural Considerations: The behavioural considerations imply that the effectiveness of an integration method depends on (a) the extent corporate managements represent their shareholders views and aspirations, and (b) the relation between payouts of dividends and the marginal rate of individual income tax. Consequently, experience in OECD countries shows that there are marked differences in the effectiveness of methods aiming tax integration at the corporate level as against those aiming at the shareholders' level. In general, integration at the shareholders' level may have less influence on business decisions if managements are not concerned with individual taxes.

Rvenue Considerations: The revenue considerations imply that any move away from a non-integrated system to an integrated system amounts to tax rate relief either at the corporate level or at shareholder level, and in the short run, results in a fall in the tax yield. Integration at the corporate level is likely to be more expensive and the decline is faster than that at the shareholders' level. Though the loss can be made up by hiking the tax rate on retained profits, such an increase is not without adverse effects. Comparatively, the revenue loss may be lower if integration is attempted at the shareholders' level. However, the advantage is more apparent than real.

Administrative Considerations: From the point of view of administrative convenience, tax integration at the corporate level is relatively easier to administer than at the shareholders' level. In fact, any approach which looks to the shareholder for collection of corporate taxes must device more efficient system of tax collection. In a developing country, this consideration is important for making the choice among methods of integration. However, integration at the shareholders' level might actually improve the tax compliance since the tax benefit would be available only to those individuals who declare the dividend income. As a matter of fact, a withholding tax can be levied to improve the tax compliance of the shareholder.

5. Towards a Company-level Dividend Deduction System for India.

While devising an appropriate tax integration method for India, the choice criteria kept in mind are as follows. The integration method should (a) aim at mitigating the differential taxation of distributed and undistributed profits, (b) help achieving some degree of parity between taxation of interest and equity incomes, (c) be simple and administratively feasible.

The above considerations suggest that company level integration is perhaps, more appropriate for Indian conditions. Being a developing country, the tax collection mechanism is not yet as efficient as to effectively administer methods aiming at shareholder level integration such as the Imputation or tax credit systems. In fact, past experience with such a system ('grossing-up' of dividends in the hands of shareholders) was not very encouraging. Further, among the two broad types of methods seeking integration at the corporate level, the *split rate system* would involve prescribing seperate tax rates for distributed and undistributed profits. However, the tax rate prescription is but arbitrary.

Therefore, the study favours the *Primary Dividend Deduction* type of schemes where a portion of dividends is deducted before taxing the corporate profits. If all dividends are exempt, then corporate profits tax becomes a tax on undistributed profits. The dividend-deduction methods have the advantage of being simple and are no more complicated than the familiar interest-deduction. They are also well-established devices and currently used in Scandinavian countries, well-tried by France and Japan for a number of years before World War II, and favoured by the Royal Commission in Canada to imputation system.

A. Theoretical Rationale.

Theoretical rationale for dividend deductibility is also straightforward. As mentioned in section 3 above, the justification is based on the phenomena of widening gap between ownership and control associated with the modern corporate form of business and the distinction between a shareholder and a bondholder fast thinning out. Therefore, by deducting a portion or full dividends from the tax liability, the same preferential tax treatment given to interest income is extended to the equity income. Yet, since the case for full exemption of equity income is also not strong, only a portion of dividends is allowed as tax deductible. The portion is referred variously as `primary', `normal' or `basic' dividend. Dividend distributions beyond the `normal' are regarded as `excess' profits, paid to the shareholder as a compensation for sharing the entrepreneurial risk that may not be entitled for distribution relief. Thus while that portion of return paid to the shareholder as a `creditor' is tax deductible, the return paid as a reward for risk-taking need not be tax deductible. In this way a parity is achieved with interest payments.

B. Operational Aspects.

Determination of 'Normal' Dividend.

A problem faced while adopting this method of tax integration is determining the portion of dividends to be exempted. Two methods are in vogue for this purpose. One is to relate the amount of deductible dividends to the rate of interest on borrowed funds. The amount deductible may be equivalent to the average interest rate on long term borrowings of the company. However, it would seem reasonable that the rate of deductible 'primary' dividend should infact be somewhat lower than the market rate of interest, since a shareholder enjoys, in addition to the dividend, future capital gains on his shares. To compensate for these potential gains he may be willing to accept a lower current yield than a bondholder would be. The dividend-deduction method takes into account the difference between the interest rate and the rate acceptible to the shareholder, commonly known as the 'yield-gap'. To illustrate, let the interest rate on long term borrowing be 15 per cent. Then the 'primary' dividend is taken to be less than 15 (say 12) per cent of the paid-up capital. Limiting the tax relief to a 'normal' dividend that is less than interest rate also ensures the purpose of discouraging profit distributions cutting into the requisite amounts of retentions needed in the business. Needless to say that the dividend relief is denied to dividends paid to other corporations.

Certain problems are likely to arise if the tax deductible dividends are expressed as a per cent of paid-up capital. Firstly, this practice would imply determination of the 'normal' dividends by taking into account only the original issue price of shares. If these shares change hands later at higher prices, over time the money invested by new shareholders would be much higher than the paid-up capital. Thus a rate of return computed on only the original share value might be mistaken as higher than 'normal' leading to the creation of sham excess dividends. In some countries that adopted this method came round the problem by making the deduction available only for new shares. Secondly, any dividend rate chosen by the tax authorities to limit the tax deduction is likely to influence the dividend pay-out policies of the company with least regard to the business needs for profit retentions. An alternative method of determining the 'primary' dividends is to express them as a per centage of actual dividends paid. Although this method is less likely to interfere with the actual dividend policies of companies, rather than solving, it avoids the problem of computing proper 'normal' dividend rate, thus makes the relationship of the deduction to the interest rate, somewhat tenuous. Therefore, even an approximate form of capital based determination is prefereable.

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