CHAPTER VIII

TAXATION OF CONTROLLED COMPANIES

In India, one of the notable features of company taxation is the set of provisions which prescribe compulsory distribution of a specified proportion of the profits of all those companies which are generally known as "controlled companies". The controlled companies may be private companies or closely-held public companies i.e. those in which the public are not substantially interested. Since these companies are subject to the application of section 23-A of the Income tax Act, they are sometimes termed as section 23-A companies.

The main objective of section 23-A is to check evasion of super tax on personal incomes by those persons who may be controlling the management of the controlled companies. They can reduce their liability to personal super tax, when it is higher than the rate of tax on the company, either by reducing or deferring the distribution of the profits of the company. The profits retained in this way can be distributed when their incomes from other sources are low or can be used to finance their consumption through various ways and means. Hence, section 23-A provides for regulating the distribution of profits by such companies.

Some questions which may be raised at this stage of discussion are: What are those companies to which section

23-A applies ? What is meant by "the public are not substantially interested ? Some persons wrongly regard only small private companies as section 23-A companies. In fact, section 23-A applies to private and public companies both. Under the Indian Income tax Act, there is no "private" or "public" company as such. These terms have not been defined anywhere in the Indian Income tax Act, nor the meaning given to them under the companies Act of 1956. As a matter of fact, there is no difference in any basic principle employed in the assessment of "private" or "public" companies. Both are treated alike. Therefore, section 23-A equally applies to public and private companies in which the public are not substantially interested.

The sentence "public are not substantially interested" would obviously raise a question as to what are those companies in which public are said to be substantially interested. The companies in which public are substantially interested have to satisfy the following conditions:-

(a) If it is a company owned by the Government or in which not less than 40 percent of the shares are held by the Government.

(b) If it is not a "private company" as defined in the Indian Companies Act, 1913 (VII of 1913); and (i) its shares (not being shares entitled to fixed rate of dividend, whether with or without a further right to participate in profits) carrying not less than 50 percent of the voting power have been allotted unconditionally to, or acquired unconditionally by, and were throughout the previous year beneficially held by the public (not including a company to which the provisions of this sub-section apply);

Provided that in the case of any such company as is referred to in sub-section (4), this sub-clause shall apply as if for the words "not less than fifty percent", the words "not less than forty percent" had been substituted.

(ii) the said shares were any time during the previous year the subject of dealing in any recognised stock exchange in India or were freely transferred by the holder to other members of the public; and

(iii) the affairs of the company or the shares carrying more than 50 percent of the total voting power were at no time during the previous year controlled or held by less than six persons (persons who are closely related such that they could be treated as a single person).

Provided that in the case of any such company as is referred to in sub-section (4), this clause shall apply as if for the words "more than fifty percent", the words "more than sixty percent" had been substituted.

The implications of the above-mentioned conditions may be briefly mentioned as follows:-

(a) A company in which 40 percent or more of the shares are owned by the Government is necessarily a company in which the public are substantially interested.

(b) For the other companies claiming to be non-section 23-A companies which do not satisfy condition (a) above, should satisfy the following conditions:-

(i) The company should not be a "private company" as defined in the Indian Companies Act. Even if it is a public limited company, 50 percent or more of its shares (i.e. ordinary shares) should have been allotted to, or acquired unconditionally by, and held throughout the "previous year" by the public.

(ii) It is not merely sufficient that the prescribed percentage of the shares, 50 percent or 40 percent as the case may be, of the company should have been held by the public, but it is also necessary that the shares held by the public should have been at any time during the previous year dealt with in any recognised stock exchange in India and should have been freely transferable in the market.

(iii) It is necessary that more than 50 percent of the shares should not have, at any time during the previous year, been controlled or held by less than six persons.

On the basis of the above mentioned conditions for a company in which public are substantially interested, it becomes possible to discuss the other side i.e. conditions governing section 23-A companies. If 51 percent of the total shares of a company are held by a public (non-section 23-A) company which will only be one "person", the remaining 49 percent being held by as many as 49 persons, the company will still be said to be a company in which the public are not substantially interested and hence subject to section 23-A. So also, even if 90 percent of a company's shares are held by a public company, the remaining 10 percent being held by 10 persons or more, the company would be regarded as one in which the public are not substantially interested. But, if a company's shares are entirely held by a public (non-section 23-A) company, the former will not come under section 23-A. Thus, it becomes clear that a company owned entirely by another public company cannot be said to be a section 23-A company; whereas a company which is largely owned by a public company along with an insignificant number of other persons will be said to be a section 23-A company.

Further, if 40 percent of the shares of a company are owned by the Government, it would be a non-section 23-A company, even if the remaining 60 percent shares are held by one person only. But, if 39 percent of the shares are held by the Government and the remaining 61 percent shares held by five persons, it would be a section 23-A company. Thus, the difference of only one percent in Government ownership would change the whole position under the law in regard to tax liability of a company. Taking up an another case where 31 percent of the shares of a company are held by a public (non-section 23-A) company, 20 percent shares by the Government, 20 percent shares by one person and the remaining 29 percent by any number of persons, in law the company will be regarded as one in which the public are not substantially interested, since more than 50 percent of the shares are held by less than six persons (by a public company and the individual).

The above-mentioned explanation of section 23-A companies shows that despite a number of conditions laid down to explain whether a company is a section 23-A company or not, some loop-holes are bound to creep in. In fact, section 23-A has become a target of severe criticism and a number of suggestions for its modifications or abolition of some of its provisions were made by a number of persons to the Taxation Enquiry Commission of 1953-54.

About the application of section 23-A, one important point to be remembered is that in actual practice, this section is not applicable to branches of foreign companies. Also, it is not applicable to the subsidiaries owned wholly by foreign public companies in which, within the meaning of section 23-A, the public are substantially interested. Ofcourse, there is nothing in law to prevent the application of this section to foreign private companies. However, the section affects foreign investments in Indian subsidiaries of foreign private companies or closely-held public companies and foreign minority holdings in Indian companies that fall under section 23-A.

As regards the history of section 23-A, by 1930, a number of instances were brought to the notice of the Government of India in which the distribution of profits was withheld with a view to escaping the liability to super tax. And, later on, these profits were withdrawn as loans free of interest. Therefore, in 1930, section 23-A was first enacted to check the tendency of withholding the profits and thereby escaping the super tax liability. The provisions of this section followed closely the U.K. law on the subject.

Under section 23-A, it was provided that if a company, which was controlled by not more than five members, had failed to distribute a reasonable proportion of its profits, having regard to its existing and contingent business needs, the Income tax officer was empowered to treat such a company as if it were a partnership. The additional demand raised under this provision was, however, recoverable from the company and not from the shareholders.

In course of time, the criterion of "reasonable needs" of the companies was found to be less practical in its application. Therefore, on the basis of the recommendation of the Income Tax Enquiry Committee of 1936 to which the problem of "reasonable needs" was referred, the provision regarding the "reasonable needs" was amended in 1939. According to the amended provision, all those companies in which the public were not substantially interested were asked to distribute 6o percent of their profits less tax as divideds. Further, a provision was added that under certain circumstances, the proportion of 60 percent could be raised to 100 percent. If a company failed to distribute the necessary foreign portion of its profits, the Income tax officer could pass an order assuming the balance to have been distributed as dividends, and recover tax thereon at the rates appropriate to the personal incomes of the shareholders, either from the shareholders themselves, or, if this was not possible, from the company.

It was in 1939 when the old provision was amended by the Amendment Act of 1939 that section 23-A could be given a more distinct and permanent shape. This lasted upto 1955-56. Before passing of the Finance Act of 1955, broadly speaking, the principle was that if a private company, to which section

23-A applied, failed to distribute 60 percent of its distributable profits (i.e. assessed profits minus taxes) to its shareholders as dividends, its entire distributable profits were deemed to have been distributed and the entire amount was assessed as dividend income in the hands of the shareholders and was included in their respective total incomes. In this way, the shareholders were made to suffer super tax on the whole of the distributable profits coming under their respective shares, if the company did not distribute 60 percent of them. Ofcourse, it was possible for them even then to avoid super tax on 40 percent of the distributable profits by not distributing that part, if they chose that course of action. This proved to be a complication.

The other complication was that often the assessments of many shareholders were completed long before the assessment of the company; and if, section 23-A was applied to its assessment later, it amounted to reopening of the assessments of the shareholders. This entailed unnecessary work and also delay in the collection of super tax. These complications continued till 1955 when new scheme, which is in force till today, was introduced.

For the purpose of section 23-A, companies are classified as investment or holding companies, industrial companies and companies partly acting as an industrial company and partly acting as any other company. In the light of this classification of companies, the Finance Act of 1955 laid down that if a section 23-A company did not distribute the prescribed amount of dividend, namely, 100 percent for investment or holding companies, 50 percent for industrial companies and 60 percent for the third type of companies, of its distributable profits, it should be subjected to "penal super tax" at the rate of 8 or 6 or 4 annas in the rupee on the undistributable balance-- the rate of super tax depending on the type of company and the year for which the assessment was made. The shareholders were to be assessed on the actual amount of dividends received by them. In a way, the amount of super tax likely to be evaded by the shareholders on account of non-distribution of profits could be recovered to a certain extent from the company itself. Ofcourse, under the law, it was open to the shareholders to choose which course could be more beneficial to them, whether or not they should make the company actually distribute ~~profits~~ prescribed minimum of distributable profits, say 50 percent or 60 percent or 100 percent, as the case may be. In this way, it was possible for them to avoid the application of section 23-A, or alternatively they could make the company suffer penal super tax. In this matter, the shareholders' choice greatly depended on their personal incomes. If their personal incomes stood at a level quite high so as to attract super tax at a rate higher than the rate of 4 annas in the rupee for 1955-56 and 1956-57 and 6 annas for the years 1957-58 and 1958-59, etc., they might like the company to pay penal super tax under section 23-A. On the contrary, if the personal incomes of the shareholders were low such that their total tax liability under super tax came to be less than that of the company under section 23-A, they would prefer that the company should distribute the prescribed amount of dividend and thus avoid the application of section 23-A. Especially, the big shareholders of private companies would prefer to make their companies to be subjected to section 23-A.

With effect from 1957-58, the rate of penal super tax to be paid by section 23-A companies was raised from 4 annas to 6 annas in the rupee. It is now levied at the rate of 37 percent. Therefore, the shareholders' choice as pointed out in the preceding paragraphs has been restricted. Now, only those shareholders whose incomes are very high so that they are subject to income-cum-super tax rate higher than 37 percent may find it profitable to ask their companies to pay extra super tax under section 23-A.

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One notable feature of section 23-A provisions as amended under the Finance Act of 1955 was that it enabled a company to carry forward to future years the excess, if any, of an actual profit distribution over the minimum distribution, required of it under section 23-A in a later year. In other words, if in any "previous year", the distribution of dividend was less than the prescribed minimum required to be distributed under section 23-A for that year, whereas if in one or more of the three immediately preceding "previous years", dividends distributed were in excess of the prescribed minimum required to be distributed under section 23-A in those respective years, the deficiency in the year under consideration could be compared with the excess or excesses in the said years, and if it was found that it was entirely covered up by the excess brought forward, section 23-A would not be applicable in the year under consideration. Further, the balance of the excesses over the deficiency in respect of any year so covered up, would be carried forward to future years for covering up any similar deficiency in such future years. However, this arrangement was subject to the condition that in respect of any year of deficiency, the excess brought forward from the past years that could be taken into account to cover it up, should be related only to the three years immediately preceding the year of deficiency in respect of which an order under section 23-A was being contemplated.

If the deficiency in any year was so large that it could not be covered up by the excesses of the preceding three years, section 23-A order would have to be passed in respect of the year of deficiency. But, in that case, the whole of the excesses of the past three years would be carried forward as such and would be available for being set-off against the deficiency, if any, arising in future years.

Though the provisions regarding setting off the deficiency in respect of any year against the excess brought forward were laid down on 1.4.1955, they were to come in effect from the assessment year 1956-57.

Another feature introduced under the Finance Act of 1955 was that it gave a right to the section 23-A company to request the Commissioner of Income-tax concerned that it might be permitted to distribute as dividends sums less than the prescribed minimum amount mentioned in section 23-A. The company had to apply for this purpose within the period of 12 months. Then the Commissioner of Income tax had to take into account the current requirements of the company. If he was satisfied that the declaration or payment of dividend would be unreasonable, he reduced the amount of the minimum distribution required of that company to such a figure as he considered fit. He also determined the period within which such distribution should be made. If the company was not satisfied with the decision of the Commissioner of Income-tax, it had a right to forward its case for reconsideration to a Board of Referees. These provisions were, however, abolished in 1957. According to the Finance Act of 1957, the question of review will be confined to the losses incurred by a company in earlier years or to the smallness of the profits made in the previous year.

In 1956 when the excess dividends tax was introduced, one anamaly in regard to super tax liability of section 23-A companies arose. On one hand, a company in which the public are not substantially interested had to pay penal super-tax at the rate of 4 annas in 1956-57 or 6 annas in 1957-58, if the profits distributed by it as dividends fell short of the minimum distribution required of the company under section 23-A, while, on the other hand, if the same dividends which it distributed under the compulsion of section 23-A, exceeded 6 percent of the paid-up capital, it had to bear extra super-tax on excess dividends. This amounted to overlapping of liabilities to super-tax payable by a company under the provisions of section 23-A and those laid down in the excess dividends tax introduced by the Finance Act of 1956. This anamaly has been removed with the abolition of the excess dividends tax in 1959.

The Finance Act of 1957 made certain amendments in section 23-A. These amendments were as follows:-

(1) The statutory percentage of minimum distribution of profits, as fixed for different classes of companies under the original section 23-A were altered. Under the original scheme, all companies whose business consisted wholly or mainly in the dealing in or holding of investments were asked to distribute the whole of the available profits as dividends (i.e. the whole of net income after taxation). Industrial companies were required to distribute 50 percent of the available profits as dividends. Non-industrial companies had to distribute 60 percent of their available profits as dividends. However, any company, whether industrial or non-industrial, was expected to distribute whole of its available profits as dividends, if its accumulated profits and reserves exceeded either the aggregate of the paid-up capital of the company and the loan capital or the actual cost of fixed assets, whichever of those two was greater.

The following table shows the changes introduced in 1957 in the position of section 23-A companies in regard to the minimum percentage required to be distributed as dividends

Class of Company	Minimum percentage required to be distributed as dividends to escape the penalty super tax.	
	Upto 1957	After 1957
Investment or Holding companies	100 percent	100 percent
Industrial companies	50 percent	45 percent
(a) a company partly acting as an industrial company, only for that part	60 percent	45 percent
(b) Any other company whose accumulated profits and reserves exceed either the paid-up capital, loan capital or the actual cost of the fixed assets of the company, whichever is greater	100 percent	90 percent
Any other company	60 percent	60 percent

Based on sources: Budgets for 1956, 1957 and 1958

(2) The procedure for adjudication by the Commissioner of Income tax or the Board of Referees for permitting the company to distribute a lesser amount of dividend than that it was otherwise required to distribute under the provisions of section 23-A, were done away with. This action was justified on the ground that very reasonable percentages of minimum distribution were proposed as shown in the above table.

(3) The provisions which enabled a company to carry forward the excess in distribution over the minimum in one year and to

set it off against the deficiency of future years, were proposed to be omitted from the Act.

The Finance Act of 1958 provided for relief in excess dividends super-tax payable by section 23-A companies. The marginal rate applicable to distribution of dividends by these companies over 18 percent of paid-up capital was proposed to be reduced from 30 to 20 percent. The rates of the excess dividends tax for companies in which the public are substantially interested were 10 percent, 20 percent and 30 percent on the slabs of dividends over 6 percent, 10 percent and 18 percent respectively, of the paid-up capital. The Finance Act of 1958 fixed the tax rates for section 23-A companies only in two slabs, 10 percent on the slab of dividends over 6 percent of paid-up capital, and 20 percent on the slab over 10 percent of paid-up capital. This change which in a sense was in favour of section 23-A companies was justified in view of the provisions of section 23-A which compelled such companies to distribute a large proportion of their profits to shareholders if the companies wanted to avoid the penal super tax under the section.

Under the Finance Act of 1959, the excess dividend tax was abolished. Therefore, the above-mentioned relief automatically vanished. A relaxation of the statutory distribution can now be permitted only with regard to the losses incurred by a company in early years or to the smallness of the profits made in the previous year.

The issue of withdrawal of the right of the companies to appeal to the Commissioner of Income tax was referred to the Direct Taxes Administration Enquiry Committee of 1958. It was represented to this committee that the existing provisions of section 23-A were rigid and caused some difficulties in business expansion. This committee was requested to provide for some flexibility.

But, this committee did not feel it necessary to introduce any change in the provisions regarding statutory distribution, on the ground that the prescribed statutory minimum for distribution was quite reasonable. The committee also pointed out that only in about 3 percent of the assessments of section 23-A companies did the need arise for levying the penal super tax. In other words, only a small proportion of companies found it necessary to distribute less of the profits than the statutory percentages. Ofcourse, it can be counter-argued that the penal tax itself might have proved to be a deterrent to a number of companies to retain profits for expansion.

As regards the economic effects of section 23-A on the growth of small and medium size companies, it should be remembered that most of the private companies are of small or medium size. "It will be seen that more than 95 percent of the private companies at work have paid-up capital less than Rs.10 lakhs and about 90 percent of the newly registered companies have authorised capital less than Rs.10 lakhs"(1). The small companies after having reached a certain size find it profitable to change their form of organisation, say, from proprietorship to private company. But, in this matter, the obligatory provisions of sections 23-A come in their way.

The problem whether reforms in section 23-A are necessary or not will be discussed in chapter XI. At present, this section has become the hotbed of controversy. Indeed, the Government has been recently trying to offer some exemptions. For instance, section 23-A now does not apply to a company 100 percent of whose shares are held by a non-section 23-A company. Further, one exemption conferred recently by the Finance Act of 1961 is for a company 75 percent of whose share capital is held by a charitable institution or a fund whose profits are exempt under section 4(3) is exempt from section 23-A. Indeed, it may be admitted that the original aim of this section of preventing avoidance of personal super tax by individuals has been fully achieved.

(1) Taxation and Private Investment, 1961, by N.C.A.E.R., page 59.