2. INFLATION AND CORPORATE ACCOUNTS

1. Introduction

A persistent rise in the general price level, implying a continuously falling value of money, is generally termed as inflation. Inflation has been a widespread phenomenon during the last decade and still continues to trouble many economies. It affects the entire monetised sector of any economy in one way or another, and since the monetised sector is predominant in most economies, the causes of inflation and the possible methods of controlling and curing it are important issues that have been discussed extensively.

The effects of inflation have also been discussed at length. It has been shown that it has economy-wide repercussions, and, though it is not a phenomenon which directly affects the real magnitudes, it certainly affects them indirectly. The major economic effects of inflation are, in brief, as follows:

(*i*) It redistributes real income between the fixed income groups and others. When income is fixed in terms of money, higher prices imply lower real income;

(*ii*) It normally causes a redistribution of real resources between the private and public sectors. This is because taxes generally rise more than proportionally with prices; if the prices of public goods do not rise faster than the rate of inflation, as is likely, the real resources available to the public sector would increase. However, the reverse seems to be happening in India;

(*iii*) Since rising prices give rise to a tendency to convert cash into commodities, especially the more durable ones, inter-temporal and inter-industry allocation of resources is distorted;

(*iv*) Relative fixity of interest rates causes savings to fall and borrowings to rise, which, in the presence of administered rates of interest, causes imbalances in the capital

market with consequent spurt in speculative activities; and

(*v*) It changes the relative prices of imports and domestic goods, causing exports to fall and imports to rise, with consequent balance of payment difficulties and exchange rate problems. In the presence of fiscal or physical controls on imports, it gives a boost to smuggling.

Inflation has a number of other direct and indirect effects which can be either short-term or long-term or both. This study concentrates on the second major effect listed above. More specifically, one of the ways in which inflation causes a tax burden higher than that legislated for the taxpayers forms the subject of this study.

2. Inflation and Taxes

Inflation leads to a higher tax burden on certain taxpayers even when the real tax base remains the same. This happens when the base is defined wholly or partially in nominal terms and the tax happens to be progressive. In the case of specific duties, the government actually loses real revenue due to inflation and the real burden of the tax is reduced. The two distinct ways in which inflation imposes additional tax burden on taxpayers are explained below in brief. It should be emphasised that these effects are not inherent to inflation, but arise due to a combination of certain tax rules and inflation. A change in the tax rules can neutralise the effect in so far as these two specific effects are concerned.

First, a progressive rate structure operates on the nominal value of the tax base. With inflation, the base increases in nominal terms and may cross over into a higher tax-rate slab even when it remains the same in real terms. Then the effective tax rate could rise with the real tax base remaining the same. This may happen in respect of a tax like, say, the personal income tax. By defining the tax base in real terms, say, indexing it to inflation, this effect can be neutralised.

The other way in which the tax base swells only in nominal terms is as follows: the taxable base is normally arrived at after certain deductions from a gross base like gross profits or gross receipts. During inflation the gross base may increase in

nominal terms, but some of the deductions, e.g., depreciation allowances in the case of corporate income tax, do not increase because they are defined in a way which is invariant to inflation. As a result the taxable base in nominal terms increases faster than that in real terms during inflation.

Thus, it is the method of computation of the tax base and the tax structure that determine the impact of inflation as far as taxpayers are concerned. Since corporate capital income is subject to corporate income tax, a brief outline of the corporate accounting methods and the tax structure would be relevant.

3. Corporate Accounting

All companies prepare their annual accounts to enable themselves as well as others interested to assess their financial position and performance during the year. The annual accounts are divided into two parts: the balance sheet and the profit and loss account. The former is a snapshot of the finances of a company on a particular day—the day the accounts are closed for the year—by listing its assets and liabilities. Sometimes the balance sheet is substituted by a sources and uses of funds account, but it is not significantly different from the balance sheet because the liabilities are normally the sources and the assets are normally the uses of funds. In practice, the only difference between the two is that under sources and uses of funds account, net current assets (current assets minus current liabilities) are taken as uses of funds. In a conventional balance sheet current assets and current liabilities are separately enumerated as parts of assets and liabilities, respectively.

The profit and loss account, also called the income and appropriation account or income and expenditure account, details the financial inflows and outflows of a company during the course of its accounting year. It states the income of the company from all heads, the various expenses incurred, profits (or loss, as the case may be) and their allocation. In case of loss, the account gives information on how the extra expenses have been financed.

The link between the corporate income tax and corporate accounting should now be obvious. The accounts form the basis of the assessment of taxable profit by the income tax authorities. This is not to say that the profits arrived at in the

corporate accounts form the tax base. In fact, the tax base is calculated as accounting profits plus disallowed expenses minus deductible allowances not deducted in the accounting profits. But it can be said that accounting profits broadly form the tax base.

The profit and loss account contains a head called tax provision which, by convention, means provision for the corporate income tax. This denotes the amount set apart to meet income tax demands. Tax provisions are not necessarily the same as actual tax liabilities, but over the years they generally even out.

Corporate accounts are generally prepared under certain accounting rules and conventions. These have evolved over the years with a view to presenting a true and fair picture of the financial operations of a company during the accounting year and of its financial position at the end of that accounting year. The persons making use of these accounts are many: the company itself, financial analysts, actual and prospective shareholders, economists, and various government agencies, among others. All these groups are now seized of the problems of the impact of inflation on corporate finances and more specifically corporate accounting. It is argued that with persistent inflation corporate accounts presented in the traditional way do not give a true and fair picture of the finances of the companies any more. Therefore, it is argued, the accounts must adjust for inflation in some way, and the government must also take cognisance of this fact.

4. Inflation and Corporate Accounting

Corporate accounting is always done in money terms and one of the underlying assumptions is that the value of a unit of money does not change over time. Thus, the accounts contain entries in money terms, the real values of which are supposed to remain unchanged for as many as fifteen years or more. Keeping nominal values unchanged under inflationary conditions is obviously incorrect. Suppose, for example, that the nominal value of the fixed assets of a company grows at a rate of 5 per cent per annum and the rate of inflation is, say, 7 per cent per annum. Thus, the growth in the nominal value of fixed assets camouflages the fact that real fixed assets are actually declining. This situation is eminently probable if one only

looks at the values given in the balance sheet of a company, because fixed assets are reported at nominal historical cost.

But more serious than this is the way values expressed in terms of money units relating to different years are used together in certain calculations, the results of such calculations becoming erroneous in the process. Specific examples are depreciation calculations, and the calculation of increase/decrease in stocks.[1] These calculations, in turn, affect the calculation of profit. Since nominal values of assets, profits and other items from corporate accounts form the basis of many other decisions having important effects, like tax liabilities calculations, action under MRTP Act, actions regarding various controls imposed by the government, and so on, the distortion in corporate accounts introduced by inflation may have a much wider effect than a mere misrepresentation of accounts.

5. The Corporate Income Tax Structure

The corporate income tax is in general levied on business organisations registered as companies with the Registrar of Companies under the Companies Act, 1956. The profits of the company, as determined by the existing tax laws, form the tax base. The rates applicable are notified by the government from time to time. The latest rate schedule is given on page 8.

The rates, as can be seen, differ according to the type of company. The two major classifications adopted for tax purposes are:

(*i*) Domestic and foreign; and
(*ii*) Closely-held and widely-held.

Foreign and closely-held (a company in which the public are not substantially interested) companies have to bear a higher rate of tax. An element of progressivity was introduced into the corporate income tax rate structure by taxing small public limited companies at a lower rate than others. But since the overwhelming bulk of capital was, and continues to be, in the larger companies, the actual impact of such progressivity

[1]The major distortions are discussed in detail later.

was not much; it was done away with in 1984 by abolishing tax-rate differentiations on the basis of income.

Rates of Income Tax on Companies

(Assessment Year 1986-87)

	Per cent
1. *Domestic Companies*	
a. Companies in which public are substantially interested (widely-held)	50
b. Companies in which public are not substantially interested (closely-held)	
(i) Trading or investment companies	60
(ii) All others	55
2. *Foreign Companies*	
a. On royalties and technical fees on agreements made with the government or with private parties with government approval	50
b. On rest of the income	65

From the total income of the company, the expenses deemed reasonable for earning that income, including depreciation on assets employed, are deducted and profits pre-arrived at in this fashion. Certain allowances—which are normally incentives for various purposes—are further deducted from the profits and the resultant amount forms the tax base. These deductions and allowances may vary across companies resulting in varying effective tax rates.

6. Objectives of the Study

The primary aim of this study is to assess the impact inflation has had on the taxation of capital income originating in the corporate sector. To this end, first an attempt is made to adjust the corporate accounts for inflation. Taxable profits of companies are then re-estimated after the adjustment, keeping other things the same. The difference between the actual effective tax rate and the estimated effective tax rate provides a measure of the extent of over/under-taxation of the corporate sector under the corporate income tax. Also, assuming the tax provision to be the same, retained profits are re-estimated after

adjustment for inflation to ascertain if there is any truth in the charge that the corporate income tax, coupled with inflation, is hampering ploughback of profits and actually causing a drain on the reserves in real terms.

There is no unique method of inflation accounting, i.e., adjusting the accounts for inflation, and the term is not unambiguous. Therefore, we start with a discussion of inflation accounting and indicate the method that will be employed by us.