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Tax Company Expenditure Not Income

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The system of taxing company incomes that uses net profit as the basis for determining the tax liability reduces the incentive to save and encourages expenditure. The tax authorities are conscious of the bias that this concept induces. That is why they take various steps- including those essentially arbitrary-to restrict the urge of companies to inflate even legally permissible expenses by not being frugal. Taxmen either disallow certain categories of expenditures or to use a commonly employed term, ‘add back’, for calculating taxable income, different proportions of expenses appearing under different expenditure heads; on the plea that the amount disallowed is an estimate of the non-business aspect of the expenditures. It should be obvious that the tax authority’s adoption of such a practice introduces discretion in the assessment of taxable income. Hence, one of the charges of harassment of the taxman.

In this writer’s view the problem is far too fundamental and serious to be left to either the discretion of the tax authorities or to some amendments in tax rules. There is a need to curb wasteful expenditure in an effective manner. The tax laws do not incentivize to ‘economize’ and frugality in spending habits. If anything, there is an in-built premium in favour of wasteful expenditures. They encourage owners or directors to camouflage personal consumption expenditure as business expense, so high is the personal gain from espousing such a policy. Increasing company expenditure by a few percentage points can yield a tax free benefit of many times the net personal incomes of those individuals from say dividends on their share holdings.

The application of such an approach by the income tax authorities is inefficient in checking profligacy. These practices act as a disincentive to the capital accumulation required for accelerating the pace and raising the level of investment. Building and maintaining lavish lifestyles in the shape of hugely expensive offices and residences, luxury chauffer driven limousines, large entertainment bills, frequent foreign travel of families at company expense, etc. are practices that get a fillip from the taxation philosophy to tax net profit, doing immense harm to the dire need to cut down extravagance and high living. All this becomes possible because such ’benefits’ can be hidden in the many expense heads that can be used to disguise the nature of the activity performed. There are a whole range of expenditure categories that can be used for hiding what are essentially expenses of a personal nature.

The rule that only those expenses would be admissible in estimating taxable income provided they are wholly and exclusively for the purposes of business is extremely difficult to apply because the concept underlying “purpose of business” can be viewed differently by different parties. What to a particular businessman is critical expenditure for promoting business may be wasteful or non-business even from the point of view of another businessman let alone the taxman. And no major benefits are likely to be derived through further amendments in the rules or laws to tackle the confusion arising from the notion and perception of an exclusively business expense. Therefore, it would be naïve to presume that such procedures and habits can be dealt with effectively under this entrenched philosophy.

Hence, the urgent need to reform the system of company taxation that can tackle the problem of avoidable and gratuitous expenditure. From the discussion it should have become apparent to a perceptive reader that the best way to deal with this disease would be to tax expenses rather than profits.

The objective of a good tax policy should be to curb profligacy and consumption and promote savings and thereby capital accumulation and investment. The taxation of expenditure can make a significant contribution to capital accumulation by deterring the urge to spend heavily on inessentials or on expenditures that are essentially of personal nature which support the lavish lifestyles of directors or owners at company expense. The other advantage of this approach would be that the more efficient and productive users of a given set of resources would pay, in proportionate terms, a smaller amount of tax than the inefficient users of the similar set of resources, thereby introducing a welcome bias in favour of efficient users of scarce resources, particularly raw materials, energy and capital. Such a strategy would also be in line with the viewpoint of taxing consumption underlying the government's commitment to the IMF and our development partners that its tax reform agenda includes the extension of GST to the retail level.

However, some adjustments would have to be made in the implementation of this approach. To begin with, an important component of business expenditure includes wages. A tax on total business expenditure would work against the more important objective of increasing employment opportunities. It will be awkward to view lightly such an issue in a labour abundant economy. Therefore, to deal with this concern it may be desirable to exclude wages from the costs deemed liable to the expenditure tax. The wage bill to be treated as an admissible expense may be further categorized into earnings below and above a certain level of wage. And the wage costs of those earning below a certain level/amount may be treated as the only admissible non-taxable business expense of the company.

In this writer's view depreciation should be treated as taxable expenditure. But if this treatment is considered to be too harsh then the existing basis of tax depreciation allowances may continue to be accepted as admissible expenditure.

Finally, so as not to discourage investment in new projects and enterprises operational expenditures for the first two to three years of commercial production (the formative years) could either be exempted from tax or taxed at a lower rate.