TAXATION OF TRANSNATIONAL INCOME

Prepared
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PREFACE

The National Institute of Public Finance and Policy is an autonomous, non-profit organisation, whose major functions are to carry out research, do consultancy work and undertake training, in the area of public finance and policy.

This study on the taxation of transnational income has been undertaken by the Institute at the instance of the Associated Chambers of Commerce and Industry of India. The study aims to cover the problems relating to the taxation of foreign companies in India as also the taxation of the foreign income of Indian companies.

The Institute decided to undertake this study because of the intrinsic importance of the subject. Government have recently modified policies relating to foreign investment in India because of the desire to encourage the flow of investment from abroad to increase the supply of savings and also because the Indian economy has become strong enough to be able to interact with the international economy. However, foreign investment and the transfer of foreign technology are allowed only on the conditions laid down by Government so that the drive to self-reliance would not in any way be affected adversely by the nature of foreign enterprises.

While many aspects of economic policies relating to foreign investment in India and Indian investment abroad have been modified to achieve the above mentioned objective, taxation of transnational income does not seem to have received adequate attention, although certain types of income accruing to foreign companies have been given concessional treatment. Tax problems faced by the Indian companies operating abroad also require attention. The present study analyses the tax situation in relation to transnational income and puts forward a set of recommendations for changes in the law which may be undertaken as part of the rationalisation of direct tax laws which we understand is under the active consideration of the Government.

The study was carried only by Shri K.N. Balasubramanian, Consultant at the Institute. The Governing Body of the Institute does not take responsibility for any of the views expressed by the authors in the studies brought out by the Institute. The responsibility for the views expressed relates to the Director and the staff and more particularly to the author of the Report.

New Delhi
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R.J. Chelliah
Director

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(K N Balasubramanian)

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I. INTRODUCTION

In India, as in most developing and newly independent countries, taxation policy is closely inter-linked with the economic policies of the Government. Before Independence, the tax laws in India were primarily geared to raising revenues for running the Government. After Independence, the accent has been on raising resources for development in a wider sense rather than on the narrow objective of raising tax revenue. The tax laws of the country have come to be oriented towards providing the needed incentives to promote savings and investments, to encourage generation of internal resources, to accelerate economic development and to regulate foreign trade in the best interests of the country so as to encourage the build up of the country's foreign exchange resources at the same time providing impetus to internal development. The country's policy of taxing foreign nationals and non-residents including foreign companies also reflects this approach.

2. The first announcement of industrial policy (6 April, 1948) made soon after Independence envisaged a mixed economy in which public and private enterprises would coexist, the former having a monopoly only in certain fields of national importance like arms, atomic power, railways, etc.. This was followed by the Industries (Development and Regulation) Act, 1951 which introduced a policy of licensing intended to promote industrial development along socially desirable lines.

In 1956, a new industrial policy was announced in the context of the country's decision to strive towards the establishment of a socialistic pattern of society. The new policy sought to accelerate economic growth, develop basic industries, increase employment opportunities and improve the working conditions and standard of living of the masses. The policy also laid accent on the reduction of the existing disparities in the distribution of income and wealth and on preventing the concentration of economic power in the hands of a few to the common detriment. The revision of economic policy in 1970 and again in 1973 sought to assign definite roles and areas of operation to different categories of entrepreneurs and to set restrictions on the monopoly business. This industrial policy continued till 1977. In 1980 fresh industrial policy broadly based on the industrial policy resolution of 1956 come to be enunciated emphasising, inter-alia, the following macro-economic objectives:

i. optimum utilisation of the installed capacity;

ii. maximising production and achievement of higher productivity;

iii. higher employment generation;

iv. correction of regional imbalances through a preferential development of industrially backward areas;

v. strengthening of the agricultural base by according a preferential treatment to agro-based industries and promoting optimum inter-sectoral relationships;

vi. faster promotion of export-oriented and import-substitution industries;

vii. promoting economic federalism with an equitable spread of investment and the dispersal of returns amongst widely spread over, small but growing units in rural as well as urban areas; and

viii. consumer protection against high prices and bad quality.

3. The Government's policy on foreign private investment in India is aimed at welcoming such investment on a selective basis in areas where that would be of advantage to the Indian economy. Foreign enterprises were also required to conform to the general requirements of the Government's Industrial Policy' and the policy aimed at progressive Indianisation of all foreign concerns. Foreigners were to be encouraged to trade <u>with</u> India and not trade <u>in</u> India. Purely trading concerns were required to change over progressively to manufacturing. Foreign concerns were also required to operate through Indian subsidiaries and not foreign branches. The foreign holdings in such subsidiaries were also to be reduced to the levels stipulated from time to time. The Foreign Exchange Regulation Act, 1973 (FERA) and the guidelines issued under the Act from time to time were meant to ensure this progressive shift in the nature and extent of the operation of foreign concerns in India. An exception to the rule of progressive Indianisation has been made only in the case of air and sea transport and banking and this has been done on a reciprocal basis, Indian concerns being allowed similar facilities in other countries. In the case of banking, an added reason for allowing foreign concerns to operate foreign branches rather than foreign subsidiaries is possibly that the global assets of a foreign banks would provide a better security to the Indian depositors than only the Indian assets of a subsidiary.

4. Indian subsidiaries of foreign companies are regarded as Indian companies and not as foreign companies for the purpose of our direct tax laws. In the matter of taxation and tax concessions, they stand on a par with purely Indian companies as the tax laws do not discriminate between one Indian company and another on the basis of the country of origin of the major shareholders. On 31.3.1982 there were 101 subsidiaries of foreign companies operating in India with assets aggregating to nearly Rs 2,500 crore. Table I.1 presents the distribution of such subsidiaries according to the country of origin of the foreign holding company.

TABLE I.1

Indian Subsidiaries of Foreign Companies: Distribution By Country of Origin of Foreign Holding Company as on 31.3.1982

(Amounts in Rs crore)

Sl. No.	Country of origin of foreign holding company	Number of Indian subsidiaries	Paid-up capital of Indian subsidiaries	Paid-up capital held by foreign holding company	Assets of Indian subsidiaries
1.	U.K.	68	225.98	130.58	1596.34
2.	U.S.A.	18	64.44	37.30	332.95
3.	West Germany	4	28.14	14.39	188.23
4.	Switzerland	4	22.16	15.15	88.85
5.	Sweden	3	12.56	6.59	72.22
6.	Canada	2	30.65	16.90	171.10
7.	Panama	1	10.05	7.03	29.18
8.	Denmark	1	0.05	0.03	0.74
	TOTAL	101	394.03	227.97	2479.61

Note: Of the 101 Indian subsidiaries of foreign companies, financial data on 95 companies relate to the year 1981-82 while those for the remaining 6 companies relate to an earlier year.

Source: Government of India, Ministry of Law, Justice and Company Affairs, Indian Subsidiaries of Foreign Companies as on 31.3.82.

Of these 101, wholly owned Indian subsidiaries were only 18, 14 of them with assets of Rs 24.50 crore being subsidiaries of U.K. companies and 4 with assets of Rs 4 crore, of USA companies. The industry-wise distribution of the 101 subsidiaries of foreign companies was as follows:

TABLE I.2

Indian Subsidiaries of Foreign Companies: Distribution by Industry as on 31.3.1982

(Amounts in Rs crore)

Sl. No.	Industry		Number of subsidiaries	Paid-up capital of subsidiaries	Assets of subsidiaries
	(1)		(2)	(3)	(4)
1.	Agriculture and allied activities (0)		19	31.95	179.84
	Of which				
	a. Tea (0.30)		19	31.95	179.84
2.	Mining and quarrying (1)		1	0.14	0.36
3.	Processing and manufacturing foodstuffs, textiles, leather, metals and chemicals (2,3 & 4)		61	359.22	2269.09
	Of which manufacture of				
	a. Motor vehicle and parts	3.22	3	31.67	306.99
	b. Electrical machinery	3.39	10	68.04	359.18
	c. Machinery other than transport & electrical	3.49	9	10.72	107.42
	d. Aluminium ware	3.51	2	31.60	169.44
	e. Medical & pharmaceutical preparations	3.80	14	65.92	291.22
	f. Washing soap and detergents	3.82	1	29.16	239.95
	g. Rubber and rubber products	4.40	3	27.68	234.25

TABLE I.2 (Contd.)

(1)		(2)	(3)	(4)
	h. Iron and steel (basic) 3.00 & and non-ferrous metals 3.10	3	17.53	141.02
4.	Construction and utilities (5)	1	0.01	0.04
5.	Commerce (trade & finance) (6)	12	1.60	17.78
6.	Transport and communications (7)	-	-	-
7.	Community and business service (8)	4	1.10	9.78
8.	Personal and other services (9)	3	0.02	2.72
	TOTAL	101	394.04	2479.61

Notes: 1. Figures in brackets in Column 2 denote Industrial Classification code (The Industrial Classifications codes allotted to the subsidiary companies are on the basis of the Revised Industrial Classification of Joint Stock Companies appended at the end).

2. See also footnote on Table I.1.

Source: Same as for Table I.1.

5. As against the above, as on 31.3.1982, there were 311 foreign companies operating through branches in India. For purposes of the direct tax laws these are regarded as foreign companies or non-resident assessees. The present study concerns itself primarily with the tax problems of these companies as also other foreign companies who may not have branches in India but nevertheless become liable to income tax in India in respect of their income which the law regards as accruing or arising in India (a discussion on this appears later in this Report). Table I.3 presents an analysis of the branches of foreign companies operating in India as on 31.3.1982 according to the country of incorporation of the parent company.

TABLE I.3

Branches of Foreign Companies in India As On 31.3.1982 Distribution by Country of Incorporation of Parent Company

Sl. No.	Country of incorporation of parent company	Number of branches	Assets of Indian branches	
	(1)	(2)	(3)	(4)
			(Rs crore)	
1.	U.K.	129	1685.00	(112)
2.	U.S.A.	62	871.64	(47)
3.	Japan	19	81.98	(18)
4.	France	10	76.65	(7)
5.	West Germany	7	9.08	(4)
6.	Italy	7	1.45	(3)
7.	Canada	6	0.54	(3)
8.	Bangla Desh	5	0.35	(5)
9.	Pakistan	5	2.45	(3)
10.	Switzerland	5	1.96	(2)
11.	Hong Kong	5	0.13	(3)
12.	Sweden	5	0.05	(3)
13.	Netherland	4	74.04	(3)
14.	Australia	4	0.01	(3)
15.	Belgium	3	1.26	(1)
16.	Yugoslavia	3	3.61	(3)
17.	Uganda	3	-	-
18.	Nepal	3	0.37	(1)
19.	Thailand	3	0.02	(1)
20.	Singapore	2	-	-
21.	Bahma-Islands	2	0.02	(2)
22.	Lebanon	2	-	-
23.	U.A.E.	2	0.03	(1)
24.	Panama	1	4.77	(1)
25.	Kuwait	1	-	-

TABLE I.3 (Contd.)

	(1)	(2)	(3)	(4)
26.	Liberia	-	-	-
27.	Luxumbourg	1	0.10	(1)
28.	Tanzania	1	-	-
29.	Iran	1	-	-
30.	Aden	1	-	-
31.	Greece	1	-	-
32.	Malayasia	1	-	-
33.	Mauritius	1	-	-
34.	Austria	1	0.11	(1)
35.	Denmark	1	0.01	(1)
36.	Srilanka	1	-	-
37.	Ethopia	1	-	-
38.	South Korea	1	-	-
	TOTAL	311	2815.63	(229)

Notes:
1. Figures in brackets under column 4 denote the number of branches to which the assets relate.
2. Out of the 229 branches whose assets have been given, the assets of 119 branches are for the year 1981-82 whereas those of the remaining 110 branches relate to an earlier year (data for the year 1981-82 in respect of these branches are not available).
3. Assets of 119 branches referred to above, amounted to Rs 2,690.72 crore and those of 110 branches amounted to Rs 124.91 crore.

Source: Government of India, Ministry of Law, Justice and Company Affairs <u>Branches of Foreign Companies in India as on 31.3.1982</u>.

6. The industry/activity-wise classification of the above branches is given in Table I.4.

TABLE I.4

Branches of Foreign Companies in India as on 31.3.1982 Distribution by Industry/Activity

(Amounts in Rs crore)

Sl. No.	Industry/Activity		Number of branches	Assets of branches	
	(1)		(2)	(3)	
1.	Agriculture and allied activities	(0)	42	44.11	(39)
	Of which				
	a. Tea plantations	(0.30)	41	44.11	(39)
2.	Mining and quarrying	(1)	5	35.24	(4)
	Of which				
	a. Copper mining	(1.13)	1	27.01	(1)
	b. Coal mining & manganese ore	(1.00) & (1.12)	3	8.23	(3)
3.	Processing and manufacture	(2,3 & 4)	34	19.08	(31)
	Of which				
	a. Aerated and mineral waters & other beverages	(2.42)	1	1.96	(1)
	b. Jute spinning & weaving	(2.64)	5	34.03	(5)
	c. Iron and steel	(3.00)	3	2.18	(3)
	d. Ship building	(3.20)	1	Nil	(1)
	e. Motor vehicles parts	(3.22)	1	Neg.	(1)
	f. Electrical appliances other than lamps & fans	(3.39)	1	0.12	(1)
	g. Machinery other than transport & electrical	(3.40)	9	17.94	(8)
	h. Medical & pharmaceutical	(3.80)	4	16.55	(4)
	i. Perfume, cosmetic & other toilet preparations	(3.81)	2	1.05	(2)
	j. Petroleum refineries	(4.00)	2	34.33	(2)

TABLE I.4 (Contd.)

(1)		(2)	(3)
k. Coke-ovens including operation of coke-ovens other than gas works	(4.01) & (4.09)	3	10.97 (3)
4. Construction and utilities	(5)	11	6.38 (10)
5. Commerce (trade & finance)	(6)	57	2572.05 (49)
Of which			
a. Wholesale trade in foodstuffs	(6.00)	3	0.12 (2)
b. Wholesale trade in commodities other than foodstuffs	(6.01)	29	4.24 (24)
c. Retail trade in foodstuffs	(6.11)	1	0.04 (1)
d. Real estate land and estate companies	(6.2)	2	0.25 (1)
e. Insurance	(6.40)	3	3.20 (3)
f. Banking	(6.50)	15	2563.35 (15)
g. Investment, trust and chit-fund	(6.52) & (6.59)	4	0.85 (3)
6. Transport, communication and storage	(7)	36	4.56 (6)
7. Community and business services	(8)	45	18.68 (36)
8. Personal & other services	(9)	7	2.22 (5)
9. Liaison/representative		74	13.31 (49)
TOTAL (of main industrial classifications)		311	2815.63 (229)

Notes: 1. Industrial Classification codes are given within brackets under column 2.

2. Figures in brackets under column 4 denote the number of brackets to which the assets relate.

3. See also footnote under Table I.1.

Source: Same as for Table I.3.

7. Whetheras the above data based on the compilation made by the Department of Company Affairs show that there were only 311 branches of foreign companies in India as on 31.3.1982 the income tax statistics show a much higher figure of assessments made on foreign companies as would be seen from the following:

TABLE I.5

Data on Assessment of Foreign Companies in India

Financial year	Number of assessments made	Tax demand (Rs crore)
1978-79	1189	64
1979-80	1201	85.5
1980-81	1241	74.3

Source: Directorate of Inspection (Research, Statistics & Public Relations), All India Income Tax Statistics, 1978-79, 1979-80 and 1980-81.

8. The statistics presented in the Report of Comptroller and Auditor General project a slightly different picture. The data reported in the Report for 1981-82 are as given in Table I.6.

9. The reasons for the variations between the different sets of figures could be several. Firstly, while the figures of the Department of Company Affairs show the position as on 31.3.1982, the income tax assessment figures relate to earlier years. The process of Indianisation could have tended to reduce the number of foreign companies operating through branches. Secondly, the income tax statistics are based on the number of assessments made in a

TABLE I.6

Data on Foreign Companies as Seen in the Report of the Comptroller and Auditor General

	Number	Amount (in rupees crore)
I. Cases where returns had been filed for the assessment year 1981-82 and assessments completed, as on 31 March, 1982:		
1. Number of foreign companies	209	
2. Income returned		25
3. Income assessed		28
4. Gross demand		9
5. Demand outstanding out of (4) as on 31 March, 1982		-
6. Tax paid upto 31 March, 1982 (4 - 5)		9
II. Cases where returns had been filed for the assessment year 1981-82 but assessments were pending as on 31 March, 1982.		
1. Number of foreign companies	426	
2. Income returned		122
3. Gross demand, being tax due on income returned		45
4. Demand outstanding out of (3) as on 31 March, 1982		1
5. Tax paid upto 31 March, 1982 (3 - 4).		44
III. Cases where no returns had been filed for the assessment year 1981-82 as on 31 March, 1982.		
1. Number of foreign companies	401	

Source: Union Government (Civil) Revenue Receipts, Volume II - Direct Taxes Report of the Comptroller and Auditor General of India for the Year 1981-82, p. 11.

financial year and not on the number of assessees in a given year. Thirdly, and more importantly, income tax assessments are often made on foreign companies which have no branches in India, either directly or through an agent in India, on their income which the law deems to accrue in India on account of what the law regards as business connection in India. Some of these assessments might not have survived an appeal. Sometimes, such assessments come to be made in respect of some solitary transactions. The variation notwithstanding, the figures set out above do demonstrate, however, roughly, the dimensions of the problem of taxation of foreign companies. Neither in terms of number nor in terms of revenue can they be regarded as a major constitutent of the taxpayers in India. The complexities involved in their taxation, however, seem to be disproportionately large. From the point of view of the nation's economy, they constitute an important and sensitive sector and the impediments that could be created by the tax laws and the attendant procedures could go counter to the economic policies in pursuance of which they have been allowed to function in India. It is therefore clear that the taxation policy in regard to foreign companies has to be shaped not by purely revenue considerations but in the broader prospective of the country's economic policies and development programmes. Similarly, the taxation policy in regard to the foreign income of Indian companies has to be guided more by economic considerations than by fiscal considerations alone. The taxation of transnational income thus assumes great importance. The present study is aimed at identifying the problem areas in the field of taxation of transnational income and finding ways and means of making the law and procedures more rational and less burdensome so as to ensure that the long term objectives of our economic policies are not defeated by the over emphasis on the short term objective of revenue collection.

II. EVOLUTION OF THE CORPORATE TAX LAW IN INDIA

a. Definition of company

10. The corporate tax law in India has undergone evolutionary changes in the context of the political changes in India and the changes in the economic philosophy of the government in power. The Indian Income Tax Act, 1918 defined a company in the following terms [Section 2(7)]

> "Company" means a company as defined in the Indian Companies Act, 1913, or formed in pursuance of an Act of Parliament or of Royal Charter or Letters Patent, or of an Act of the legislature of a British Possession, and includes any foreign association carrying on business in British India whether incorporated or not, which the Governor General in Council may by general or special order, declare to be a company for the purposes of this Act;

The definition was slightly modified when the Indian Income Tax Act, 1922 was passed [Section 2(6)] in the context of the setting up of the Central Board of Revenue. The definition read as follows:

> "Company" means a company as defined in the Indian Companies Act, 1913, or formed in pursuance of an Act of Parliament or of Royal Charter or Letters Patent, or an Act of the Legislature of British Possession, and includes any foreign association carrying on business in British India whether incorporated or not, and whether its principal place of business is situated in British India or not, which the Central Board of Revenue may, by general or special order, declare to be a company for the purposes of this Act;

The definition remained intact till India became independent and a definition of the term 'Indian Company' was introduced in a new clause (7A) in Section 2 of the Indian Income Tax Act, 1922 by the Indian Finance Act, 1948. Indian Company was defined as meaning"a company as defined in the Indian Companies Act, 1913, the registered office of which is situate in British India". Correspondingly, the definition of the term 'company' in clause (6) was substituted as follows:

'Company'means:

i. any Indian company,

ii. any association, whether incorporated or not and whether Indian or non Indian, which is or was assessable, or was assessed as a company for the assessment for the year ending on 31st day of March 1948, or which is declared by general or special order of the Central Board of Revenue to be a company for the purposes of this Act;'

The definition has been amended from time to time and, as of date, the definition of a company in Section 2(17) of the Income Tax Act, 1961 reads as follows:

"Company" means:

i. any Indian company, or

ii. any body corporate incorporated by or under the laws of a country outside India, or

iii. any institution, association or body which is or was assessable or was assessed as a company for any assessment year under the Indian Income-tax Act, 1922 (11 of 1922), or which is or was assessable or was assessed under this Act as a company for any assessment year commencing on or before the 1st day of April 1970; or

any institution, association or body, whether incorporated or not and whether Indian or non-Indian, which is declared by general or special order of the Board to be a company; provided that such institution, association or body shall be deemed to be a company only for such assessment year or assessment years (whether commencing before the 1st day of April, 1971, or on or after that date) as may be specified in the declaration);

b. Corporate tax rates

11. Companies were subjected to a flat rate of tax on their entire income from the inception of the Indian Income Tax Act, 1922. The income tax rate on companies remained stable at 18 pies in a rupee (9.375 per cent) from 1922-23 to 1929-30. In 1930-31 the rate was stepped up to 19 pies in a rupee (9.89 per cent). From 1931-32 till the outbreak of World War II (1938-39) the rate was 26 pies in a rupee (13.54 per cent). Apart from income tax there was also a supertax on companies as in the case of other taxable entities. During the entire pre-war period from 1922-23 to 1938-39 the super tax rate for companies remained constant at 12 pies in a rupee on income exceeding Rs.50,000 (6.25 per cent). Thus, the total tax burden on a company on the eve of the World War II was 13.54 per cent on income not exceeding Rs.50,000 and 19.79 per cent on the excess. These rates were the same for all companies irrespective of their residence or nationality.

12. During the war years (1939-40 to 1945-46) the income tax and super tax rates on companies were stepped up. From 1940-41 a surcharge also came to be levied. A rebate of super tax at the rate of one anna[1/] in the rupee on the undistributed profits was introduced for the first time in 1944-45, the rebate being allowed to a company on the total income as reduced by the amount of any dividend declared in the taxable territories, not being a dividend payable at a fixed rate, in certain cases. At the close of the war, (1945-46), the total burden of income tax and super tax on these two categories of companies was 41.99 per cent in cases where the rebate was admissible and 48.24 per cent in other cases.

13. During the assessment years 1946-47 to 1948-49 there were changes in the rates of income tax and super tax and in the scheme of allowance of rebates.

The Indian Finance Act, 1949 raised the basic super tax rate to 4 annas in a rupee and modified the schedule of rebates. As a result, the total tax burden for 1949-50

Small domestic public companies	6 annas in a rupee	(37.5%)
Other domestic companies public & private	7 annas in a rupee	(43.75%)
Public non-domestic companies and their subsidiaries	8 annas in a rupee	(50.00%)

1/ 1/16th of a rupee.

Other non-domestic companies	9 annas in a rupee	(56.25%)

Thus, the gap between domestic and non-domestic companies in the matter of tax rates widened and, with the dawn of Independence, domestic corporations came to be given a more favoured treatment in the matter of rate of tax. The gap has ever since been maintained though its extent has varied from time to time (Annexure A.) Table II.1 summarises the rate differential for some selected years:

TABLE II. 1

<u>Tax Rates on Companies in Percentages (Excluding Special Levies Like Excess Dividend Tax and Bonus Tax, and Ignoring Concessional Rate for Industrial Income, Dividends, Royalties, Capital Gains, etc.</u>

Assessment Year	Domestic Companies: Small widely-held	Domestic Companies: Other widely-held	Domestic Companies: Closely held	Non-domestic companies: Widely-held	Non-domestic companies: Closely-held
1950-51	34.375	40.625	40.625	46.875	53.125
1955-56	37.1875	43.4375	43.4375	52.8125	55.9375
1960-61	40	45	45	63	
1965-66	42.5	50	60	65	
1970-71	45	55	65	70	
1075-76 (including surcharge 5%)	47.25	57.75	68.25	73.5	
1980-81 (including surcharge 7½%)	48.375	59.125	69.875	75.25	
1984-85 (including surcharge 5%)	57.75	57.75	68.25	73.5	

Source: Annual Finance Acts.

A noteworty feature is that the tax rates on companies which were substantially reduced in 1960-61 kept rising thereafter reaching a peak in 1980-81 and 1981-82 when the rates including surcharge touched the levels of 48.375 per cent for small widely-held companies, 59.125 per cent for other widely-held companies, and 69.875 per cent for closely-held companies. If surtax and the statutory disallowance of certain kinds of expenses are taken into account the burden would be much higher.

c. <u>Other features of corporate taxation</u>

14. With the insertion of a provision in the Indian Income Tax Act, 1922 in 1930 (Section 23A) for bringing to tax the undistributed income of closely-held companies in the hands of the shareholders as if the income had been distributed, a distinction came to be made between companies in which the public were substantially interested (commonly referred to as widely-held companies) and others (closely-held companies). In later years, this distinction became material for determining the rates of tax and a few other purposes. The definition of a company in which the public are substantially interested which was in Section 23A of the old Act, was also accordingly included in the common definitions Section 2 as Clause (18) in the new Act instead of in Sections 104 to 109 which incorporated the provisions of Section 23A of the old Act.

15. The late fifties and early sixties witnessed further important changes in the corporate tax structure. The Finance Act, 1956 omitted the provisions relating to

deemed distribution of dividends by a closely-held company which had failed to distribute the statutory minimum percentage of its distributable income as dividends and, instead, introduced a provision for levying additional supertax on the company itself on the undistributed balance thus delinking the assessment of the company from the assessments of its shareholders. The delinking process was carried further by the Finance Act, 1959, which abolished grossing up of dividends thus bringing about a change over from the imputation system to the classical system of taxing corporate income. The Wealth Tax was levied on companies from the assessment year 1957-58 but remained inforce only for 3 years upto assessment year 1959-60 after which it was abolished. The law also experimented with levying a higher rate of corporation tax when the company distributed excess dividends or when it issued bonus shares. In 1963, a super profits tax was levied on "the excessive" profits of companies. This was replaced by the surtax on companies in the very next year and this levy has continued till this day with changes in the rate structure. From 1965-66 income tax and supertax, charged separately till then, were merged into a single levy of income tax. From 1.4.1975 a ceiling of 70 per cent of the total income has been put on the combined burden of income tax and surtax on a widely-hled domestic company whose paid-up share capital subscribed and paid for in cash is not less than 25 per cent of the capital computed for surtax purposes. The Wealth Tax on Companies has been revived by the Finance Act, 1983 with effect from 1.4.1984 but will be restricted in its application only to certain assets of closely-held companies.

Treatment of inter-corporate dividends

16. The pattern of taxation of inter-corporate dividends also witnessed some important changes over the years. The Finance Act, 1953 inserted a new Section 56A in the Indian Income Tax Act, 1922 providing super tax exemption in respect of dividends received by a company from an Indian Company formed after 31.3.1952 and engaged in one of the specified priority industries listed in the section itself. The provision was incorporated in Section 99(i)(iv) of the Income tax Act, 1961 when that Act replaced the 1922 Act with effect from 1.4.1962. The list of industries was transposed to the Fifth Schedule to the new Act. In the meanwhile, the Finance Acts had introduced a concession in the super tax rate in respect of the dividend income of a foreign company from an Indian subsidiary regardless of the nature of its business. Under the Finance Act, 1957 the benefit was allowed to all companies, domestic or foreign, receiving dividends from an Indian subsidiary. The Finance Act, 1960 extended the benefit further to dividends from other Indian companies (not being subsidiaries) though at a somewhat lower rate. With effect from 1.4.1964 the system of super tax rate rebate in the Finance Act was given up and super tax exemption of inter-corporate dividends was uniformly provided for all companies in Section 99(1)(iv) of the main Act itself which was till then restricted in its application to dividends from companies engaged in priority industries only. This section was omitted when income tax and super tax were merged from 1.4.1965 and, instead, partial relief in respect of the aggregated income tax was provided in a

new Section 85A for inter-corporate dividends restricting the tax incidence to 25 per cent. With effect from 1.4.1968 the pattern of relief was changed providing a percentage deduction of the inter-corporate dividend income of a company in computing its total income, under Section 80M of the Income Tax Act. Under the provision as originally enacted, a domestic company got a 60 per cent deduction in respect of dividends from another domestic company while a foreign company was allowed an 80 per cent deduction from dividends received from a domestic company if the company was a closely-held company engaged in a priority industry and a 65 per cent reduction in other cases. From 1.4.1972 the higher rate of deduction (80 per cent) in respect of dividends from a domestic company engaged in a priority industry received by a foreign company was abolished. From 1.4.1976 the application of Section 80M came to be restricted to domestic companies only, foreign companies being instead subjected to a flat rate tax on 25 per cent on their dividend income (Section 115A). With effect from 1.4.1977 the deduction available to domestic companies in respect of inter-corporate dividends was raised to 100 per cent in cases where the dividends were from newly formed Indian companies engaged in certain priority industries listed in the Ninth Schedule.

III. TAXATION OF FOREIGN COMPANIES AND FOREIGN INCOME OF INDIAN COMPANIES

a. Resident and non-resident companies

17. Before Independence, the income tax law in India made hardly any distinction between Indian companies and foreign companies except that resident companies were liable to tax on their world income whereas non-resident companies were so liable only on their income from sources in British India. A company was consideres as resident in British India (a) if the control and management of its affairs were wholly in British India in that year or (b) if its income arising in British India in the relevant accounting year exceeded the income arising outside British India in that year. In the context of the then existing Indian princely States which were outside British India, this classification did not really amount to a classification based on the company being Indian or non-Indian. Further, under the 'income test' even a foreign company could come to be considered as 'resident' in one or more years. It was only with effect from 1.4.1958 that the income test was given up. Till Independence, 'residence' was determined with reference to British India only. After Independence and the progressive integration of the princely States and the French and Portuguese possessions, 'residence' came to be determined first, with reference to the 'taxable territories' and, finally, with reference to the whole of India.

b. Indian and non-Indian companies

18. As mentioned earlier, the term 'Indian company' came to be defined in the Indian Income-tax Act, 1922 for the first time only after Independence when Section 2(7A) was inserted therein by the Indian Finance Act, 1948. The definition has undergone several changes and, to-day, the definition of 'Indian company' in Section 2(26) of the Income Tax Act, 1961 is in the following terms:

> "Indian Company" means a company formed and registered under the Companies Act, 1956 (1 of 1956) and includes:
>
> i. a company formed and registered under any law relating to companies formerly in force in any part of Indian other than the State of Jammu and Kashmir and the Union territories specified in sub-clause (iii) of this clause;
>
> ia. a corporation established by or under a Central, State or Provincial Act;
>
> ib. any institution, association or body which is declared by the Board to be a company under Clause (17);
>
> ii. in the case of the State of Jammu and Kashmir, a company formed and registered under any law for the time being in force in that state;
>
> iii. in the case of any of the Union territories of Dadra and Nagar Haveli, Goa, Damman and Diu, and Pondicherry, a company formed and registered under any law for the time being in force in that Union territory.

An Indian company was automatically regarded as 'resident' too, but, a non-Indian company could also fall to be treated as 'resident' under certain circumstances. This brought into the law two overlapping concepts, namely (a) resident and non-resident and (b) Indian and non-Indian.

c. Domestic and foreign companies

19. It may be noted that, the concept of what in later years came to be referred to as a 'domestic company' (being one which had made the prescribed arrangements for the declaration of dividends in the provinces in India and for the deduction of super tax therefrom) was first introduced by the Indian Finance Act, 1948. The term 'domestic company' however, came to be formally defined only in the Finance Act, 1966, as a company which had made the prescribed arrangements for the declaration and payment within India of dividends in accordance with the provisions of Section 194 of the Income Tax Act, 1961. The definition was incorporated in Section 80B(2) of the Income Tax Act itself with effect from 1.4.1968. Simultaneously, the term 'foreign company' was also defined in Section 80B(3) as a company which is not a domestic company as defined in Clause(2). This added a third category to the existing two categories. Thus, three distinct concepts came to exist in the Income Tax Act in relation to companies, viz., (a) resident and non-resident (b) Indian and non-Indian, (c) domestic and foreign. The categories overlap to a large extent but are not quite indentical. Thus, a non-Indian company can nevertheless become a domestic company by making the prescribed arrangements for payment of dividend in India. In fact, there have been several

sterling companies which had become demostic companies. However, their number has been dwindling with the progressive Indianisation of foreign companies. Similarly, a non-Indian association declared to be a company would become an Indian company if its principal office is in India. A foreign company can become a resident if in a particular year the control and management of its affairs is wholly in India. Though the tax base (whether world income or only Indian income) still continues to be determined by the residential status of the company, the applicability of several other provisions of the law depends on whether the company is Indian or non-Indian or whether it is domestic or foreign.

d. <u>Tax rates and procedures</u>

20. While tracing the evoluation of the corporate tax structure in India, it has been mentioned that it was ony after Independence that foreign companies came to be subjected to a higher rate of tax than domestic corporations. Till the mid-fifties, widely-held foreign companies were allowed the benefit of a somewhat lower rate as against closely-held ones. This distinction has since been given up but a rate differential has been introduced with reference to the nature of the income. Thus, lower rates of tax have been fixed for income from dividends, royalty and technical fees, This has been done in the context of encouraging foreign investment in India and foreign technical collaboration with Indian concerns and in recognistion of the fact that if we did wish to obtain foreign investment and participation, the rate of tax should be kept moderate, keeping in view the tax situation in competing countries. The rates were initially

to be applied to the net income as computed under the law after allowing various expenses incurred in India or outside subject to the provisions of the Act which made no distinction between residents and non-residents in this regard.

21. With the increase in the area and extent of foreign investment and collaboration, problems naturally arose in making proper income tax assessments of foreign companies in respect of their Indian income. In the context of the high tax rates in some developing countries including India, multi-nationals found it profitable to allocate a much larger share of the head office expenses to their branches in such countries than what commercial considerations alone would have warranted. Another technique of tax minimisation was to be claim expenses which had no direct nexus with the income earned in India. Yet another technique was to arrange the transactions with Indian concerns in such a way that the income was shown as accruing or arising outside India. In the absence of account books of the foreign taxpayer, which are kept outside India, the Departmental Officers were considerably handicapped in verifying the claims for deductions and deciding on their admissibility or otherwise in computing the taxable income of the non-resident. With a view to beating these techniques and rationalising and simplifying the assessments of non-residents certain important amendments to the law were made during the years 1975 and 1976. Section 44C was introduced by the Finance Act, 1976 for regulating claims for deduction in respect of head office expenses. The provision has restricted the allowance to the <u>least</u> of the following:

i. 5 per cent of the adjusted total income i.e., total income without taking into account unabsorbed depreciation and losses of earlier years set off in the year and certain incentive allowances like investment allowance and development rebate. If there is a loss in the year the average adjusted total income of the years of profit out of the three preceeding years has to be taken;

ii. the average head office expenditure actually allowed in the assessment years 1974-75, 1975-76 and 1976-77; or

iii. the expenditure attributable to the Indian business.

The section has also defined 'head office expenses'. Section 44D, introduced by the same Finance Act, has totally barred all deductions towards expenses (and not merely head office expenses) in computing income from royalty or technical service fees prospectively and has also restricted the deduction to 20 per cent in respect of existing agreements. Under Section 115A inserted simultaneously, the income of a foreign company from royalty or technical service fees has been made taxable at a flat rate of 40 per cent. A lower rate of 20 per cent has been allowed only in respect of lump-sum royalty payments for transfer of know-how outside India. The section has also laid down a flat rate of 25 per cent for taxing dividend income. The amendments made to sections 44D and 115A by the Finance Act, 1983 has extended the procedure to income from interest on foreign currency loans which has been made taxable at the rate of 25 per cent on the gross amount without any deductions.

22. With the above changes in the law, the incidence of income tax on the Indian income of a foreign company for the assessment year 1984-85 would be as fc

Dividend income	25%	tax to be levied on gross income without any deductions - no surcharge
Interest on foreign currency loans	25%	
Lump-sum royalty for transfer of know-how outside India	20%	
Other royalties	40%	
Technical service fees	40%	
All other incomes	73.5%	including surcharge tax to be levied on the net income after allowance of expenses but restricting head office expenses in the manner discussed above.

e. <u>Non-resident shipping companies</u>

23. In regard to the assessment of the profits of non-resident shipping compenis, the process of simplification has been carried much further by reverting to the summary assessment procedure which was in vogue under the 1922 Act for tramp ships. As long back as 1923, a provision was inserted in the Indian Tax Act, 1922 (Sections 44A, 44B and 44C) to facilitate the making of a tentative assessment on the profits of non-resident shipping business deeming the income to be 1/20th (enhanced to 1/6th in 1950) of the gross amount booked by way of fare, freight, etc., at the Indian ports.

The assessment was also required to be made and tax collected before the ship was cleared for sailing from out of the port. This was an exception to the normal rule of assessing the profits of a year only in the following financial year (called the assessment year) and not in the same year. The assessee had, however, the right to seek a normal assessment in theassessment year in the usual way claiming all admissible expenses, when the amounts paid on the tentative assessments would be treated as advance tax paid towards the regular assessment. When the Income Tax Act, 1961 was enacted, a corresponding provision was included in Section 172. As it was found that difficult and complicated issues arose in apportioning the global profits between the Indian and non-Indian operations in relation to depreciation, terminal charge and various others matters, it was considered desirable to provide a statutory rule for the computation of shipping profits of non-residents. Accordingly the Finance Act, 1975 inserted a new Section 44B with effect from 1.4.1976 providing for a summary assessment of non-resident shipping profits at 7½ per cent of the earnings in India by way of freight, carrage of passengers, mail, etc., Section 172 has been allowed to remain on the statute with corresponding modification as to the profit rate to be applied. The result would be that the tentative assessment made under Section 172 in the income year would practically get equated with the normal assessment to be made in the assessment year.

f. <u>Oil prospecting, etc;</u>

24. Another provision which reflects the Government's anxiety to simplify the income tax assessments of foreign companies participating in the economic development of

India is Section 293A inserted by the Finance Act, 1981 which enables the Central Government to make an exemption, reduction in rate or other modification in respect of income tax in favour of persons with whom the Central Government enters into agreements for association or participation in any business of prospecting for or extraction or production of mineral oils or natural gas. The provision assumes importance in the context of the extension of the 'Exclusive Economic Zone of India' to 200 nautical miles from the base line by the Territorial Waters, Continental Shelf, Exclusive Economic Zône and Other Maritime Zones Act, 1976, which would make the income of the foreign companies participating in off-shore drilling liable to Indian income tax.

g. Situs of accrual of income

25. One of the most controversial aspects of the assessment of non-residents in India is the determination of the situs of the accrual of income as, unlike in the case of residents, the income which accrues or arises outside India is not taxable in their case. With the high rates of tax prevailing in India, there is every temptation to shift the situs of accrual of income outside India. This has been sought to be countered by deeming certain kinds of income arising to non-residents to accrue in India. Thus, Section 42 of the Indian Income Tax Act, 1922 provided for the deeming as accruing in British India of all income, profits, or gains accruing or arising to a non-resident whether directly or indirectly or from any business connection in British India or through or from any property in British India or through or from any

money lent at interest and brought into British India in cash or in kind. The provision was primarily enacted in the context of containing tax avoidance by Indian businessman seeking to shift the situs of accrual of their income to the then existing native States to which the Indian Income Tax Act did not extend. The substance of this provision was incorporated in Section 9 of the Income Tax Act, 1961 when that Act was enacted. An important feature of the provision was that, though all income accruing or arising whether directly or indirectly through or from any business connection in India was deemed to accrue in India, the law also provided that, in the case of a business of which all the operations are not carried out in India, the income to be deemed to accrue in India shall be only such part of the income as would be reasonably attributable to the operations carried out in India. The law also provided an exception that in the case of a non-resident no income shall be deemed to accrue or arise to him through or from operations which are confined to the purchase of goods in India for the purpose of export.

26. In the context of the several amendments made with effect from 1.4.1976 for rationalising and simplifying the assessment of non-residents, Section 9 of the Income Tax Act was also amended to provide a more certain and clear-cut source rule for certain kinds of income arising to non-residents. It was felt that the absence of a clear-cut rule sometimes created uncertainly about the chargeability of certain types of incomes in the case of non-residents. The amendment has accordingly provided the necessary source rules for income by way of interest, royalty and fees for technical services. The terms royalty and "fees for

technical services" have also been appropriately defined. Under the provision, interest payable by the Government is deemed to accrue or arise in India. Interest paid by a person resident in India is also deemed to accrue or arise in India, except in cases where the interest is payable in respect of any debt incurred, or moneys borrowed and used, for the purposes of a business or profession carried on by such person outside India or for the purposes of making or earning any income from any source outside Ind Interest payable by a non-resident is, however, deemed to accrue or arise in India only in cases where the interest is payable in respect of any debt incurred or moneys borrowed and used for the purposes of a business or profession carried on by the non-resident in India or for the purposes of making or earning any income from a source in India. Income by way of royalty payable by the Government is deemed to accrue or arise in India. Royalty payable by a person who is resident in India is also deemed to accrue or arise in India, except in cases where the royalty is payable for the transfer of any right or the use of any property or information or for utilising the services of the recipient for the purposes of a business or profession carried on outside India or for the purposes of making or earning any income from a source outside India. Royalty payable by a non-resident is deemed to accrue or arise in India only in cases where the royalty is payable in respect of any right, property or information used or services utilised for the purposes of a business or profession carried on by the non-resident in India or for the purposes of making or earning any income from any source in India. Similarly, income by way of fees for technical services is deemed to accrue or arise in India if they are paid by the Government. Such fees payable by a person who is resident in India are also deemed to accrue or arise in India, except in cases where the fees are payable in respect of technical services utilised in a business or profession carried on by the person outside India or for the purposes of making or earning any income from a source outside India. Fees for technical services payable by a non-resident are, however, deemed to accrue or arise in India only in cases where the fees are payable in respect of services utilised in a business or profession carried on by the non- resident in India or where such services are utilised for the purposes of making or earning income from a source in India.

27. The Finance Act, 1983 has made a further amendment to Section 9 of the Income Tax Act providing that, in the case of a non-resident, being a person engaged in the business of running a news agency or of publishing news-papers, magazines, or journals, no income shall be deemed to accrue or arise in India to him through or from activities which are confined to the collection of news and views in India for transmission out of India.

h. Tax incentives and exemptions

28. To complete the picture regarding the taxation of transnational income of companies in India, a reference will have to be made to the reliefs and exemptions available in respect of such income. Generally speaking, the income tax law in India does not make any distinction between domestic and foreign taxpayers in the matter of the rules for computation of taxable income except in

regard to special categories of business, like shipping, oil prospecting, etc. Many of the tax concessions are also available uniformly to all but some of them have been restricted to resident persons and domestic corporations only in the context of the policy of progressive Indianisation of industries and the accent on self-reliance. The following are the more important deductions (exemptions) which are allowable only in the case of Indian or domestic companies or resident non-corporate assessees.

Section 35B	Export market development allowance (since with drawn)
Section 35D	Amortisation of certain preliminary expenses
Section 35E	Deduction for expenditure on prospecting, etc., for certain minerals.
Section 80HHB	Deduction in respect of profits and gains from projects outside India
Section 80HHC	Deduction in respect of export turnover
Section 80MM	Deduction in the case of an Indian company in respect of royalties, etc., received from any concern in India (with drawn from 1.4.1984)
Section 80N	Deduction in respect of dividends received from certain foreign companies
Section 800	Deduction in respect of royalties etc., from certain foreign enterprises.

Most of the above incentives intended exclusively for domestic companies or resident taxpayers, relate to their foreign income earned by the export of goods, technology or services.

29. Tax liability some times arises when assets are transferred, either by way of a tax on capital gains or by way of withdrawal of a relief already granted. There are provisions which grant exemption from such tax but, usually, the benefit is available only in cases when the transferee company is an Indian company. This restriction is obviously meant to ensure that scarce capital goods are not exported out of India.

30. There are not many tax concessions which are exclusively meant for foreign companies earning income in India. Section 115A of the Income Tax Act prescribes lower tax rates for the income earned by a foreign company from dividends, interest, royalty, and technical fees and the provision is intended to provide relief from the high rate of 70 per cent plus surcharge and to bring about procedural simplification. Section 10(6A) exempting foreign companies from tax on tax in respect of tax-free royalties or fees for technical services payable by the Government or an Indian concern is mainly intended to relieve the burden on the Indian parties to the agreement who undertake to reimburse the foreign company the Indian taxes payable by them on their income by way of royalty or fees for technical services. The exemptions in respect of interest on foreign currency loans provided under Section 10(15)(iv) has to be read in the context of the provisions in Section 9 (1)(v) which deem such income as arising in India. The exemption provides some mitigation to the deeming rule.

i. Tax treaties

31. The overall incidence of tax on the transnational income of a company in its home country and the host country is to some extent modulated by a tax treaty between the home country and the host country or, in the absence of such a treaty, by provisions for grant of unilateral relief by the home country. Section 90 of the Income Tax Act 1961 empowers the Government of India to enter into an agreement with the Government of any country outside India for the following purposes:

i. for granting relief in respect of the income on which tax is paid both in India and in that foreign country; or

ii. for avoidance of double taxation of income under the Indian tax law and the corresponding law in that country; or

iii. for the exchange of information for the prevention of evasion and avoidance of income tax chargeable under the Indian Income-tax Act or under the corresponding law in force in that country, or investigation of cases of such evasion or avoidance or

iv. for the recovery of income-tax under the Indian Income Tax Act and under the corresponding law in force in that country.

The Companies (Profits) Surtax Act, Wealth Tax Act and Gift Tax Act also contain similar provisions enabling the Central Government to enter into agreements with foreign countries for the avoidance of double taxation with respect to taxes levied under these Acts. In pursuance of the power conferred by these provisions, the Government of

India have entered into tax treaties with as many as 29 countries.[1/] Most of these are comprehensive while some are limited to income from shipping and/or operation of air crafts only. A list of countries with which agreements exist is given in Annexure B. The agreement with Pakistan was operative upto assessment year 1971-72 only.

32. In general, the tax treaties aim at conferring tax jurisdiction to the source country as against the home country. In the case of businesses, the situs of the operations through a permanent establishment is determinative of the situs of the source. The profits attributable to the permanent establishment are usually those which might be expected to be made if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently of the enterprise of which it is a permanent establishment. No profits are usually to be attributed to mere purchase operations, especially those meant for export. In regard to income from the operation of air craft or ships, the general practice is to confer enclusive jurisdiction to the home country to tax the profits of international traffic. Special provisions are usually made in regard to income from dividends, interest, royalties, technical fees, etc., and income of students, professors, artists, athletes and the like. Certain general provisions relating to the elimination of double taxation are also usually included. In regard to royalties and technical fees, some of the agreements confer enclusive tax jurisdiction on the source country while others permit both the countries

1/ Government of India Central Board of Direct Taxes, Ministry of Finance, India's Tax Agreements (1983), New Delhi.

to tax the income but a ceiling is prescribed in certain cases on the tax leviable by the source country.

33. In the case of countries with which India has not as yet entered into any tax treaty, Section 91 of the Income Tax Act, 1961 provides unilateral relief to residents in India against double taxation at the lower of the rates applicable to the double taxed income in India and in the foreign country.

IV. TAX TREATMENT OF NON-RESIDENT CORPORATIONS IN OTHER COUNTRIES[1]

34. Fiscal planners in India often draw inspiration from the tax laws of other countries, both developed and developing, in an attempt to tackle various economic and developmental problems for which parallels might have existed elsewhere. In deciding on the policy of taxing foreign companies, it is not merely useful but very necessary to keep in mind the position in other countries as, both tactically and from the point of view of equity, some sort of reciprocity and parity are required in this regard. A brief survey of the pattern of taxation of non-resident companies in different countries would also be helpful in identifying some of the anomalies and inconsistencies in our law and in bringing our fiscal policies in proper alignment with our economic policies. Some salient features of the tax treatment of domestic and foreign corporations in some selected countries in Asia, Africa, Europe and the North American continents are given in the following paragraphs.

1/ Sources of information

a. Guides to European Taxation - The Taxation of Companies in Europe - Supplements upto October, 1982.

b. Income Taxes outside the U.K. - HMSO.

c. Income Taxes Worldwide - Commerce Clearing House Income.

d. Tax News Services - International Bureau of Fiscal Documentation.

e. Taxation and multinational enterprise - John F Chown - Longman.

f. Introduction to US International Taxation by Paul R. Me Daniel and Hugh J. Ault.

g. Information supplied by individual companies covered by the Study.

Tax Treatments of Foreign Companies in Selected Countries

Australia

35. A resident company is defined as one incorporated in Australia or one which carries on business in Australia and has its Central management and control there or its voting power is controlled by residents. Resident and non-resident public companies are taxed on their entire income at 47.5 per cent and private companies, whether resident or non-resident, are taxed at 45 per cent.

It is usual for the head office charges to be put through the branch's books and Australian exchange control regulations require the clearing of current accounts on a regular basis. Indirect expenses are usually allocated in the ratio of branch income to world income or to overseas income. The evidence furnished by the taxpayer is usually accepted in the first instance. The Australian legislation contains provisions which empower the tax authorities to adjust the taxable income of a foreign-controlled Australian business where the business produces either no taxable income or less taxable income than expected.

Belgium

36. Belgian companies are subject to tax at a basic rate of 45 per cent levied on their world wide income subject to lower rates on small income corporations and capital gains. The imputation system is followed. Where a Belgian company pays dividends to a non-resident shareholder, the 20 per cent withholding tax is a final

tax but may be allowed as a credit in the country of residence of the recipient. Where a Belgian company receives a dividend from another Belgian company, there is no refund of the withholding tax and 90 per cent of the receipt is exempt from tax. Non-resident corporations are taxed on their Belgium source income at 50 per cent which is higher than the rate for resident companies. There is a lower rate of 22.5 per cent on capital gains and a higher rate of 67.5 per cent on disguised commission. The tax rate may be altered by treaty regulations.

Companies which do not have their registered office, main establishment or place of management in Belgium are subject to non-resident income tax. Payment of the head office charge is not required but it should be put through branch books. Indirect expenses are allocated in the ratio of branch income to world income or branch expenses to total expenses, or branch staff to total staff or branch footings to total footings. Supporting evidence of indirect expenses is not generally required and a head office certificate is usually regarded as sufficient.

Canada

37. All resident corporations pay federal tax on world-wide income at a general rate of 46 per cent. Branches of foreign corporations pay tax at the same rate on their Canadian income. A surtax of 2½ per cent of the federal tax is also payable. A branch of a foreign company suffers in addition a 25 per cent tax on its after-tax profits minus an investment allowance. The effective rate on a branch may range between 60.85 per cent and 65.35 per cent depending on the province.

In Canada, the law does not permit foreign banks to operate through branches. Only locally incorporated subsidiaries are allowed.

Denmark

38. Companies are classified as residents, decided by place of incorporation, and non-residents. While resident companies are taxed at 40.7 per cent on their world income, non-resident companies are also taxed at the same rate on their Danish source income. In the case of the former, domestic dividends are exempted under certain circumstances while in the case of the latter, dividends from Danish sources are taxed at a lower rate of 30 per cent.

It is usual but not essential for head office charges to be put through the branch's books and for a remittance to be made. Indirect expenses are allocated on a 'reasonable' basis but consistency is expected. Auditors' opinions are usually not required. The tax authority usuallyaccepts the information furnished except in unusual circumstances when independent verification would be sought. It is a general principle of the Danish law that branches controlled from overseas will be deemed to earn such profits as might reasonably have been expected to be made had it dealt with the parent office at arm's length. Charges designed to reduce the profits artificially would be disallowed.

France

39. Branches of foreign companies are taxed in the same way and at the same rate as resident companies. The

rate of corporation tax on legal entities is 50 per cent. Dividends are entitled to a tax credit. Foreign corporations are subject to corporate income tax if they conduct business in France on the French source profits earned by them. A French registered subsidiary is always considered to be a resident.

Payment of head office expenses is not necessary. Book entries are usually expected to be made but are not regarded as a legal requirement. Indirect expenses are usually allocated in the ratio of balance sheet footings or in the ratio of branch income to overseas income. As evidence of expenses, office invoices are usually regarded as adequate. Supporting vouchers are not usually requested from the head office.

Germany

40. German companies are subject to the split rate system of corporation tax. Resident companies (i.e., those which have either seat or place of management in Germany) are taxed on their world-wide income at 56 per cent on their undistributed profits and 36 per cent on their distributed profits. Resident shareholders get imputed credit. Non-resident companies are taxed on their German source income at 50 per cent on business profits and lower rates on dividends from resident companies.

Actual payment of head office charges is not insisted on for getting a deduction from branch profits. Indirect expenses are allocated in the proportion of branch footings to total footings, branch salaries to total salaries, etc. Audited head office accounts are not insisted on. For direct expenses, internal documentation is acceptable.

Hong Kong

41. Profits tax is charged on the assessable profits at a standard rate, which in the case of companies was 17 per cent for the year 1976-77. No distinction is made between domestic and foreign companies. The term 'Corporation' is defined as a company incorporated or registered under any enactment or charter in force in Hong Kong or elsewhere but excluding a co-operative society or a trade union.

Where the true assessable profits of a non-resident from a trade, business or profession carried on in Hong Kong cannot be readily ascertained, they may be computed on a fair percentage of the turnover in Hong Kong. This is also done where the accounts of a non-resisent do not disclose the true profits of a Hong Kong permanent establishment.

Indonesia

42. Branches of foreign companies are subject to the normal corporation tax rates on their Indonesian income. Their after-tax profit is regarded as dividend and subjected to a withholding tax. Trading profits are generally taxed at 45 per cent above RP 50M. There is an excess profit tax upto 60 per cent of profits in excess of 15 per cent rate of return. Oil industry and mining companies enjoy a rate concession.

Japan

43. A company whose head office or principal place of business outside Japan is a foreign company. A Japanese branch of a foreign company is taxed on its Japanese

income in the same manner and at the same rate as a domestic corporation but the reduced rate for distributed profit does not apply. A domestic corporation is liable to corporation tax at 42 per cent, enterprise tax at 13.2 per cent and inhabitants tax ranging from 6 to 14 per cent of the corporation tax. Distributed profits are taxed at a lower rate. Enterprise and inhabitants tax are lower for small undertakings and also vary according to location. Dividends from domestic corporations are excluded from taxable income but 25 per cent of the excess of dividends received over dividends paid is included.

As regards head office charges, it is not necessary either to make payment or make entries in the branch books. Indirect expenses are usually allocated in the proportion of gross income or gross expenses. The tax authority usually accepts the information supplied by the head office and no attempt is made to refuse a deduction merely on the ground of low profitability if the expenses are otherwise reasonable.

Kenya

44. A body of persons is treated as resident in Kenya if (a) the management and control of its business **are** exercised there, or (b) it has been deemed to be a resident in Kenya by a notice in the Gazette or (c) it is a company incorporated under the law of Kenya. The rules of computation of taxable income are the same for branches of foreign companies and domestic corporations except that no deduction is allowed to a branch of a foreign company in respect of interest, management fees, etc., paid to the parent company. Foreign income is not taxable. There are special provisions for ship owners, charterers and

air transport operations. Branches of foreign companies suffer tax at 52.5 per cent as against 45 per cent for domestic corporations (27.5 per cent for mining operations for the first 4 years of profit).

Korea

45. Corporation tax is charged upon the income from all sources of a company having its head or main office in Korea (domestic company) and upon income accruing from Korean sources only where the company has its head or main office outside Korea (foreign company). Public (listed) companies and non-profit companies are charged to corporation tax at 20 per cent on the first W. 50,00,000 of taxable income and at 27 per cent on the excess. Other companies (including foreign companies) are charged at progressive rates ranging from 20 per cent upto income of W. 30,00,000, increasing to 40 per cent in respect of income over W. 50,00,000.

Malaysia

46. A company is treated as a resident in Malaysia for the basis year for a year of assessment if, at any time in that basis year, the management and control are exercised there or, where a business is not carried on, if the management and control of its affairs are exercised in Malaysia. Companies, whether resident or non-resident, are charged to income tax at 40 per cent.

No payment of the head office charge need be made. It is sufficient if they are passed through branch books. Indirect expenses are usually allocated in the ratio of branch income to world income or to overseas income. The tax authority does not seek to relate the quantum of the charge to branch profitability where an audit certificate is available. Queries are raised only when the charge is disproportionate to the branch income.

Pakistan

47. A company is regarded as resident in Pakistan in any year if, in that year, the control and management of its affairs are wholly situated there or if it has its registered office there and is either registered under the Companies Act, 1913 or formed under a Central Act. Resident companies and non-resident branches pay tax at the same rate, viz., income tax at the rate of 30 per cent and supertax rebates are allowed to companies formed and registered in Pakistan. Dividends from a registered company are taxed at the rate of 5 per cent if received by a public company at the rate of 15 per cent if received by a non-resident company and at the rate of 20 per cent in the cases of other companies.

Head office expense claims are restricted. Interest paid to head office is not allowed.

Singapore

48. A company is treated as a resident in Singapore if the control and management of its business are exercised there. All companies, whether resident or non-resident are charged to tax at a uniform rate of 40 per cent.

It is not necessary to make an actual payment of head office charges but the charges should be recorded in the branch books. Indirect expenses are allocated on a reasonable basis.

Sri Lanka

49. A company is deemed to be resident in Sri Lanka if its registered or principal office is in Sri Lanka or if the control and management of its business is exercised in Sri Lanka. Non-resident companies pay tax at the rate of 55 per cent on their taxable income. Domestic companies are taxed at lower rates - small companies at slice rates rising to a maximum of 50 per cent, companies quoted by Colombo brokers' association at the rate of 40 per cent and other resident companies at the rate of 50 per cent. For the year 1981-82 a 5 to 10 per cent surcharge has also been imposed. Dividends are subject to 20 per cent tax deduction at source, and are not taxable in the hands of corporate tax holders.

Switzerland

50. Branches of foreign companies are, in effect, not treated differently from legal entities established in Switzerland.

A payment of the head office charge is not necessary, a book entry must however, be made. Indirect expenses are usually allocated on income basis or in the proportion of expenses or in the ratio of branch footings to total footings. Generally, the branch must establish that certain management functions are assumed by the head office for the benefit of the branch.

UAE Countries

51. In Abu Dhabi and Dubai, locally incorporated companies are not subject to income tax whereas foreign controlled branches pay a 20 per cent tax. In Oman, foreign branches and foreign companies without local participation suffer tax at the rate of 50 per cent. The rate of tax is reduced to 20 per cent where Oman nationals own at least 35 per cent but less than 51 per cent of the capital and to 15 per cent where they own 51 per cent or more of the share capital. The position in Catar in similar but where a locally incorporated company is owned at least to the extent of 51 per cent by locals no tax is payable. Foreign banks pay tax at various slab rates rising upto a maximum of 50 per cent.

United Kingdom

52. As from 1.4.1973 companies pay tax at the rate of 50 per cent on their profits whether distributed or not. Where profits are distributed, they are treated as if they had borne personal tax at the basic rate of 30 per cent. A U.K. Branch of an overseas corporation is subject to corporation tax at 52 per cent on income from or earned in the U.K.. A proportion (at present 15/26) of capital gains is also chargeable to corporation tax.

Apart from the statutory authority contained in the double tax treaties, there is no specific legislation covering the deductibility of head office expenses. There is no requirement to make a physical book entry supporting the charges, nor is there any requirement that the amount should be paid to the head office. Indirect expenses are allocated on a reasonable basis adopting the criteria of branch income, ratio of expenses, ratio of staff strength, etc.

U.S.A.

53. United States companies are formally subject to a tax of 22 per cent on their income plus a surtax of 26 per cent on income excess of $ 25,000 (working out to practically 48 per cent in the case of big companies). In some years, there have been surcharges on the tax liability at rates upto 10 per cent making an effective tax rate of 52.8 per cent. There is no withholding or prepayment of tax on dividends paid to residents. There is a withholding tax of 30 per cent (reduced under certain double tax agreements) on dividends paid to non-residents. On general principles, United States companies are subject to tax on their world wide income. Credit is given to foreign tax paid on the same income subject to a maximum equal to the U.S. tax payable on the same income. Foreign corporations are generally taxed at regular corporate tax rate. If a foreign corporation is not engaged in a U.S. trade or business during the taxable year, a tax of 30 per cent is imposed on its gross income.

As regards head office charges, as in U.K. it is not necessary to debit the charges in the accounts of the U.S. branch nor is it necessary to make a physical rembursement. There are no hard and fast rules or formula for calculating the allocation of head office charges; the IRS appears to adopt a 'reasonable' approach based on comparisons of unit activity, gross sales or receipts, costs, profit contribution, etc.

Zambia

54. A person other than an individual is resident in Zambia for any charge year if the control and management of the persons' business or affairs are exercised in Zambia for that year. A branch of a foreign corporation is subjected to corporation tax in the same manner and at the same rate as resident corporations. Foreign dividends and interest are normally excluded from assessment. A Zambian company is taxed on foreign source income as well. Dividends from other Zambian companies are exempt. For the year 1981-82, the corporation tax rate was 45 per cent (25 per cent on farm income). There is a tax on undistributed profits of domestic corporations after allowing for reasonable retentions. A 35 per cent tax is levied on profits retained for more than 9 months after the close of the accounting year.

55. The position that emerges is that most of the countries treat domestic and foreign corporations alike in the matter of rate of tax. India, levying a much higher tax on foreign companies is among the few exceptions. Even among the exceptions the rates of tax applicable to foreign companies in other countries, seems to be appreciably lower than the tax rates applicable in India.

V. SOME PROBLEMS AND POSSIBLE REMEDIES

a. Need for reform

56. As mentioned at the outset, purely revenue considerations need not be given much weight while deciding on the taxation policy in relation to foreign companies operating in India. Their operation in India **is strictly** regulated by the Government. If the Government so wants, their operations can be further restricted or regulated or they can be allowed to fold up and leave1/. It is unnecessary to use income tax as an instrument for achieving control over their activities in India. In fact, trying to achieve indirectly through the tax laws what can be done directly may turn out to be counter-productive and defeat those very economic objectives for helping to achieve which the foreign companies have been allowed to operate in selected areas. In contemplating any reform to the scheme of taxation of foreign companies, it is therefore necessary to steer clear of any exaggerated notions of revenue loss.

57. A newly independent country like India aiming at fast economic development and self-reliance has necessarily to pass through various phases in its attitude to foreign investment. Prakash Tandon2/ refers to these as phases of dependence, independence and interdependence.

1/ The Hon'ble Finance Minister stated in the Lok Sabha on 2.12.1983 that 14 foreign companies which were required to dilute their non-resident interest to 40 per cent under the FERA have opted to wind up their operations in the country for their own corporate reasons.

2/ Tandon P. (1982) Transnationalisation of the Banking Activities and Financial Markets in Developing Countries - India - Supplementary memorandum to Main Report OECD.

In the first phase, the developing country is wholly or largely dependent for its inputs of manufactures, science and technology, banking, insurance and consultancy services, upon the metropolitan power that dominated it in the 19th century, directly or indirectly. It has a weak or no industrial structure and its foreign exchange needs are limited and met by exports of raw materials. In the second phase, as its own technology and services develop following upon its post-war independence, it is commonly the experience that in order to add value to its raw materials and to protect its nascent industries, it asserts its independence and creates certain barriers, and exercises a degree of selectivity in its choices of inputs from abroad. In this it is also impelled by the common experience of a shortage of foreign exchange, when the import needs are higher than the export capability, and the country is forced into a policy of import controls and substitution and a control over its directions of trade. In the third phase, it has gained perhaps enough strength to begin to appreciate the benefits of mutuality and interdependence, and the earlier insistence on self-sufficiency gives place to self-reliance, in buying such advice, services and technology abroad as is ahead of its own, while developing its own capacity to build upon the imported technology. This is a state of interdependence, where it both receives and gives. By now it has also developed an export capability, which in itself creates the compulsion to attract investment and technology more liberally. India has passed the second phase and is moving into the third phase. This is evident from the changed attitudes to foreign investment and foreign technology. In recent times, the FERA rules regulating foreign investment in India have been substantially liberalised. The same liberal attitude is visible in the policy relating to import of technology and sophisticated plant and machinery. There is increasing realisation that, for improving internal efficiency and external competitiveness India must update its technology and attract foreign investment and know-how wherever it would help its economy. India's policies in regard to foreign investment and technology is no longer merely defensive. As observed by Prakash Tandon:

> "This new phase of interdependence also coincided with the beginning of a process of transnationalisation of India's own firms and banks, who, along with skilled labour and professional talent, began activity spreading abroad, thus making transnationalisation of trade, investment and banking part of a two-way process. Foreign investment and banks are made to feel increasingly acceptable in India as Indian firms and banks were being accepted abroad - a true state of interdependence.
>
> India now invites technology more advanced than its own; and India exports technology, sometimes less developed but more appropriate to some developing countries' needs. In some cases India has a unique experience to offer, as an example, in development banking for small enterprises and farmers, an experience that banks of developed countries would not possess.
>
> India's growing integration with foreign industry, investment and banking is thus part of this new process of integration with both the developed and the developing world, related in the outward flows to its own capabilities, and in the inward flows by what it perceives as its needs. The process ofcourse also creates a growing compulsion of granting reciprocity to other countries, where Indian firms and banks have settled" 1/

1/ Ibid., p.53.

58. The same attitude of self-reliant liberalism is also visible in the Indian Government's policy towards foreign banks. Even as far back as 1969, it was realised that foreign banks had a distinct role to play in the Indian economy and they were left untouched by the nationalisation of the banking industry. Today, even though India has its own well developed network of bank and financial institutions which can very well cater to the domestic needs, there is increasing realisation that foreign banks, alonside the larger Indian banks have a contribution to make in areas of international loans, syndications and investment. They also help the Indian banking business in its process of transnationalisation and innovations and modernisation by acting as pacesetters. The need for international reciprocity has also accelerated the policy of liberalisation. Thus, simultaneously with Indian banks going transnational, foreign countries have been allowed to open branches or representative offices in India. According to recent statistics, 12 Indian commercial banks have 133 offices abroad, including 6 off-shore units in 21 countries - USA, UK, France, West Germany, Belgium, South Korea, Japan, Thialand, Hong Kong, Singapore, Bangladesh, Maldive, Seychelles, Panama, Nassau, Cyman Islands, Shri Lanka, Kenya, Fiji Mauritius, and UAE (Dubai, Abu Dhabi, Raa-Al-Quwaim, Sharjah, Oman). At the same time, 22 foreign banks have 135 offices in India in 16 towns.

59. After World War II, foreign banks have been steadily losing their share of the banking business in India and the process has accelerated after Independence

and more so after the nationalisation of the major Indian Banks, as would be seen from the data in Table V. 1.

TABLE V.1

Share of Foreign Bank - Percentages of Total

	1940	1950	1960	1969	1973	1977	1979
Branches	2.8	1.7	1.4	1.4	0.8	0.5	0.4
Deposits	27.4	17.4	11.9	9.2	7.2	4.3	3.4
Advances	27.7	24.6	16.9	10.6	7.8	4.7	4.0

Source: Tandon P.(1981) Transnationalisation of the Banking Activities and Financial Market - OECD - p.47

Branches of foreign banks constituted 2.8 per cent of the branches of all banks in 1940 and 1.4 per cent in 1969. Since bank nationalisation in 1969 this ratio has been steadily decreasing and currently 0.4 per cent is the reasons for the decline are:

- A phenomenal branch expansion of Indian banks since 1969; Nationalised Bank's branches grew from 6,596 in June 1969 to 25,774 in June 1980 resulting in a quadrupling of total number of bank branches in India from 8,262 to 32,419; while

- Foreign banks have remained static, with only two new branches opened between 1969 and 1979. New branches can be opened only with the permission of the Reserve Bank of India.

Foreign banks thus seem to pose no threat to the Indian banking industry which has come of age and has developed its own innate strength. It seems to be unnecessary, therefore, even from a protectionist angle, to subject foreign banks to a discriminatory tax rate.

60. There has been further licensing of foreign banks during the latter half of 1980. Four branches of foreign banks have been opened - Bank of Oman, Emirates Commercial Bank Ltd., European Asian Bank and Indo Suez Bank. The policy of the Reserve Bank has been to give more encouragement to the international banking community in India rather than enlarge the presence of the foreign banks which are already represented in India.

61. The liberalised policy towards foreign investment and know-how does not, however, seem to be adequately reflected in our tax system. The reforms that have been introduced in recent years are more procedural than substantive in nature. The taxation policy seems to continue to remain weighted against foreign companies operating in India even within the restricted fields allowed to them. In tune with the liberalisation of the economic policy, a basic change in the taxation policy seems to be called for. Some of the areas in which urgent reforms appear to be necessary are discussed in the following sections.

b. Definition of company under the direct tax laws, need for uniformity

62. The different direct tax laws contain different definitions of the term 'company'. These definitions are reproduced below:

Income Tax Act, 1961 - Section 2(17)

i. any Indian company, or

ii. any body corporate incorporated by or under the laws of a country outside India, or

iii. any institution, association or body which is or was assessable or was assessed as a company for any assessment year under the Indian Income Tax Act, 1922 (11 of 1922), or which is or was assessable or was assessed under this Act as a company for any assessment year commencing on or before the 1st day of April, 1970, or

iv. any institution, association or body, whether incorporated or not and whether Indian or non-Indian, which is declared by general or special order of the Board to be a company:

Provided that such institution, association or body shall be deemed to be a company only for such assessment year or assessment years (whether commencing before the 1st day of April 1971, or on or after that date) as may be specified in the declaration);

Wealth Tax Act, 1957 - Section 2(h)

"Company" means a company formed and registered under the Companies Act, 1956 (1 of 1956), and includes;

i. a company formed and registered under any law relating to companies formerly in force in any part of India;

ii. a corporation established by or under a Central State or Provincial Act;

iii. any institution, association or body, whether incorporated or not and whether Indian or non-Indian, which the Board may, having regard to the nature and object of such institution, association or body, declare by general or special order to be a company;

Provided that such institution, association or body shall be deemed to be a company only for such assessment year or assessment years (whether commencing before the 1st day of April, 1975, or on or after that date) as may be specified in the declaration;

iv. any body corporate incorporated by or under the laws of a country outside India;

Gift Tax Act, 1958 - Section 2(vii)

"Company" means a company as defined in Section 3 of the Companies Act, 1956 (1 of 1956), and includes;

i. a foreign company within the meaning of Section 591 of that Act; and

ii. a company within the meaning of any law relating to companies for the time being in force in the Union territory of Dadra and Nagar Haveli, Goa, Daman and Diu, or Pondicherry and any association in any such Union territory whether incorporated or not which is declared by general or special order of the Board to be a company for the purposes of this Act;

Estate Duty Act, 1953 - Section 2(3)

"Company" includes any body corporate wheresoever incorporated;

Apart from these definitions, certain other enactments deem certain entities to be 'Companies for the purpose of the Income Tax Act'. These independent definitions with differences, which seem to be purposeless, tend to create unnecessary confusion and add to the complexities of the law. It is desirable to have the term 'company' defined in the Income Tax Act only, the other laws merely relying on that definition. The same is true of the diverse phraseplogy used in the definition of 'principal officer' of a company in the different tax laws.

c. Classification of companies

63. The tax laws of all countries make a distinction between domestic and foreign corporations. Our law has been made unnecessarily complicated by a three-tier classification, namely (a) resident and non-resident companies; (b) domestic and foreign companies and (c) Indian and non-Indian companies. The reasons for this overlapping classification was probably 'historical' - the existence of princely States which were not part of the taxable territories and the existence of a large number of sterling companies operating in India at the time of Independence having a large number of Indian share holders, some of the companies having their shares even listed on Indian stock exchanges. Such domestic companies would, however, still retain their non-resident status, their control and management being located entirely outside India; and this creates an anomalous situation of a company being a domestic company and a non-resident company at the same time.

64. The number of companies incorporated outside India which came to be nevertheless considered as domestic companies having made the prescribed arrangements for payment of dividends in India and deduction of tax therefrom has been stadily dwindling and such companies are now near-extinct. The time seems to be now ripe for doing away with the multifold classification and have only a two-fold classification of companies as Indian and foreign, the former being considered automatically as resident and the latter as non-resident for tax purposes.

The distinct definitions of 'Indian company' in Section 2(26), 'domestic company' in Section 80B(2) and 'foreign company' in Section 80B(4) and the tests for the residence of a company in Section 6(3) can all be built into a single provision. It would also become unnecessary to have the term 'domestic company' defined in every Finance Act as is being done now. /See Section 2(7) of the Finance Act, 1983/.

65. The Wealth Tax Act and the Gift Tax Act independently law down the criteria for the determination of the residential status of a company. The tests are the same and there seems to be no reason why a company which is 'resident' for income tax purposes cannot automatically be treated as resident for all other direct taxes. Section 20A of the Estate Duty Act refers to a foreign company which has been treated as a resident in two of three years under the Indian Income Tax Act, 1922. That Act contained an 'income test' for determining the residence of a company, and a company incorporated outside could be considered as a resident if its Indian income exceeded the foreign income. Such a test, however, does not appear in the Income tax Act, 1961. The continuance of Section 20A in the Estate Duty Act in its original form even after the repeal of the Indian Income Tax Act, 1922 in an anachronism to which several expert bodies have already drawn the attention of the Government[1]. The Section serves no purpose in its present form and should be omitted.

1/ Final Report of the Direct Tax Laws Committee Para III.11.6.

66. While the tax laws have multiple criteria for dealing with foreign companies, the other economic laws contain independent definitions of 'foreign' company. The definition of a foreign company in Section 591 of the Companies Act is different from that in Section 28 of the FERA. The DGTD adopts a still different criterion for indentifying a foreign company. Such multiplicity can only create confusion and conflicts. As all the various economic and fiscal laws should be oriented in the same direction for implementing the Government's economic policies on the international plane, it is time that a uniform definition of 'foreign company' applicable to all the economic and fiscal laws is evolved.

d. <u>Declaration as company of unincorporated institutions or associations</u>

67. Under Section 2(5A) of the Indian Income Tax Act, 1922 only Indian Companies were regarded <u>perse</u> as companies. Companies incorporated outside India had to be declared to be a company by a general or special order of the Central Board of Revenue. Under the definition in Section 2(17) of the Income tax Act, 1961 any body corporate incorporated by or under the laws of a country outside India is automatically regarded as a company for the purposes of the Income Tax Act. A general or special order is necessary only in the case of unincorporated associations and institutions. Getting declared as a company was regarded as a facility to the assessee at a time when the maximum marginal rate of non-corporate income tax was as high as 97.75 per cent. With the lowering of this to 60 per cent plus surcharge,

such declaration can no longer be regarded as an unmixed blessing as the rate of tax applicable to a foreign company is 73.50 per cent on its entire income as against a maximum marginal rate of 67.5 per cent with a basic exemption of Rs.15,000 if personal income tax rates were to apply.

68. Getting declared as a 'company', however, assumes importance for institutions and associations from the point of view of wealth tax as wealth tax is not leviable on companies whereas unincorporated associations may be liable to wealth tax. The Wealth Tax Act has an independent definition of 'company' in Section 2(h). While any body corporate incorporated by or under the laws of a contry outside India is automatically regarded as a company for the purposes of wealth tax, an unincorporated association or institution has to be declared to be a company by a general or special order of the CBDT specifically under the Wealth Tax Act. The separate declarations required under the Income Tax Act and Wealth Tax Act not only create unnecessary duplication but could create anomalies. An institution might get itself declared as a company under the Wealth Tax Act to escape Wealth Tax but it could choose net to have such a declaration issued for income tax purposes for avoiding the high rate of corporate income tax on foreign companies (and possibly surtax and disallowance of expenses on the top of it). There seems to be no reason why there should not be a single declaration as company by the Board in the case of unincorporated institutions and associations serving the purpose of all direct taxes.

A legislative reform in this regard seems to be called for.

e. Closely-held and widely-held companies

69. The distinction between closely-held and widely-held companies is not now relevant in the case of foreign companies. Both Section 115A of the Income Tax Act and the annual Finance Acts make no distinction between closely-held and widely-held foreign companies in the matter of taxrates. As regards the levy of additional income tax (formerly additional super tax) on closely-held companies failing to distribute adequate dividends, it used to be regarded as purposeless to invoke the provisions against foreign companies as declaration of dividends by them would not result in any benefit to the Indian revenue. The matter has, however, been placed beyond doubt, by the amendment made by Act 13 of 1966 which provides that the provisions of Section 104 of the Income Tax Act would not apply to a company which is neither an Indian company nor a company which has made the prescribed arrangements for the declaration and payment of dividends within India. There are two other provisions in the Income Tax Act for which the distinction is relevant. Section 179 casting personal liability on the directors in respect of the tax dues of a company in certain circumstances applies only to a company which is a private company under the Companies Act, 1956, and, as such, would not apply to foreign companies even if they are closely-held; Section 79 placing restrictions on the set-off of losses of a company in which the public are not substantially interested in case there has been a large

scale change in the ownership of the shares could theoretically be invoked against a foreign company also. After the recent amendment made to the definition of a 'company in which the public are substantially interested' in Section 2(18) of the Income Tax Act by the Finance Act, 1983 making listing on a recognised stock exchange in India a mandatory conditions, all foreign companies would come to be automatically treated as closely-held for the purpose of Section 79 of the Income Tax Act. While it would be impossible in practice to apply the provisions of Section 79 to a foreign company the theoretical possibility could give rise to audit objections and it would be desirable to restrict the operation of Section 79 of the Income Tax Act to Indian companies only. In fact, the application of the provision even to Indian companies has been widely criticized and seems to have led to complications after the insertion of Section 72A providing for the set off of the losses of amalgamated sick units.

f. Concept of Business connection

70. A very controversial area in the field of taxation foreign companies is the concept of 'business connection'. Section 9(1) of the Income Tax Act deems as arising in India, inter alia, all income accruing or arising, whether directly or indirectly, through or from any business connection in India. The term 'business connection' is not defined in the Act. The 'Explanation' to Section 9(1), howecer, adds a requirement for the application of the deeming clause some part of the business operations should be carried on in India and that only the income reasonably attributable to the

operations in India would be deemed to accrue or arise in India. Courts have been applying rigorous tests for establishing business connection and, in a large number of cases the Department's attempts to rope in the income of non-residents within the Indian tax net under this deeming provision have been rendered nugatory[1/]. In CIT vs R D Aggarwal & Co. (1965) 56 ITR 20 (SC) the Supreme Court limited the ambit of the term 'business connection' as follows:

1/ Vide decisions in:

i. Carborundum Co v CIT (1977) 108 ITR 335 (SC)

ii. CIT vs Gulf Oil (GB) Ltd (1977) 108 ITR 874 (Bom)

iii. CIT v Hindustan Shipyard Ltd (1977) 109 ITR 158 (AP)

iv. CIT v Saurashtra Cement and Chemical Industries Ltd (1975) 101 ITR 502 (Guj)

v. Bikaner Textile Merchants Syndicate Ltd vs CIT (1965) 58 ITR 169 (Raj)

vi. Anglo-French Textile Co Ltd vs CIT (1953) 23 ITR 101 (SC)

vii. AP Damodara Shenoy vs (1954) 26 ITR 650 (Bom)

viii. CIT vs Blackwood Hodge (India) Pvt Ltd (1970) 76 ITR 107 (Cal)

ix. Addl CIT vs Bharat Fritz Warner Pvt Ltd (1979) 118 ITR 1018 (Kar)

x. Bharat Heavy Plate & Vessels Ltd vs Addl CIT (1979) 119 ITR 986 (AP)

xi. CIT vs Toshuku Ltd (1980) 125 ITR 525 (SC)

xii. VDO Tachometer Worke vs CIT (1979) 117 ITR 804 (Ker)

xiii. CIT vs Kirlosker Bros Ltd ITR IVO 1[illegible]8 of ID 4 decided on 31.8.1983 (Bom).

"The expression 'business connection' undoubtedly means something more than business. A business connection in Section 42 (Section 9 of 1961 Act) involves a relating between a business carried on by a non-resident which yields profits or gains and some activity in the taxable territories which contributes directly or indirectly to the earning of those profits or fains. It predicates an element of continuity between the business of the non-resident and the activity in the taxable territories; a stray or isolated transaction is normally not to be regarded as a business connection. Business connection may take several forms; it may include carrying on a part of the main business or activity incidental to the main business of the non-resident through an agent or it may merely be a relation between the business of the non-resident and the activity in the taxable territories, which facilitates or assists the carrying on of that business. In each case, the question whether there is a business connection from or through which income, profits or gains arise or accrue to a non-resident must be determined upon the facts and circumstances of the case".

71. Section 9 specifically deems certain types of income to accrue or arise in India. These are:

i. income accruing or arising through or from any property in India, or through or from any asset or source of income in India or through or from the transfer of a capital asset situate in India;

ii. income which falls under the head 'salaries' if earned in India.

iii. income chargeable under the head 'salaries' payable by the Government to a citizen of India for service outside India;

iv. income by way of interest payable by:

(a) the Government; or

(b) a person who is a resident, except where the interest is payable in respect of any debt incurred, or moneys borrowed and used, for the purposes of a business or profession carried on by such person outside India or for the purposes of making or earning any income from any source outside India; or

(c) a person who is a non-resident, where the interest is payable in respect of any debt incurred, or moneys borrowed and used, for the purposes of a business or profession carried on by such person in India;

vi. income by way of royalty payable by

(a) the Government; or

(b) a person who is a resident, except where the royalty is payable in respect of any right, property or information used or services utilised for the purposes of a business or profession carried on by such person outside India or for the purposes of making or earning any income from any source outside India;or

(c) a person who is a non-resident, where the royalty is payable in respect of any right, property or information used or service utilised for the purposes of a business or profession carried on by such person in India, or for the purpose of making or earning any income from any source in India.

When the operations of foreign companies and other non-residents in India are strictly regulated by law and when Section 9 specifically lists out the types of their income which could be deemed to accrue ~~or~~ arise in India.

it seems unnecessary to have a general provision deeming all income accruing in India directly or indirectly through or from any business connection in India as arising in India and then try to contain its unlimited potential for mischief by hemming the provision with conditions laid down in the law or through a process of judicial interpretation. When the concept was originally conceived, India had a large number of princely States within, whose inhabitants though Indian and free to carry on trade or have investments in any part of India, were nevertheless 'non-residents' for the purpose of the Indian Income Tax Act 1922. Conceived as an anti-tax avoidance measure in those days, the concept of 'business connection' seems to have out-lived its utility and, today, poses a potential threat to the economic cooperation programmes between India and other countries; Foreign collaborators, feeling insecure in the face of this 'Democle's sword' of 'business connection hanging over their heads, have been resorting to shifting their entire tax burden to their Indian counterpart by inserting a clause to that effect in the collaboration agreements. This, however, led to a situation where the revenue would impute tax on tax and esclate the tax burden on the Indian concern to unbearable levels, many of the sufferers being public sector companies and Government departments; and the legislature had to step in and amend the law providing that the tax agreed to be paid by the Indian concern would not be treated as the taxable income of the non-resident in certain cases[1/]. The controversial concept of 'business connection' merely tends to raise the cost of foreign collaboration for India and does not seem to produce any substantial revenue. Till now, courts used to intervene to thwart unduly wide interpretation of the

1/ Clause 6(A) of Section 10 inserted by the Finance Act, 1983 with effect from 1.4.1984.

provision; but once the burden falls on the Indian concerns, the non-residents may not bother to pursue the dispute through courts. Some rethinking on the utility of retaining the business connection clause in the deeming provision in Section 9 of the Income Tax Act seems to be necessary.

g. Simplification of computation of income of foreign companies

72. The difficulties in making a fair computation of a non-resident company's income have come to be realised and the recent trend has been to simplify the procedure in such a way as to eliminate minute scrutiny of books of account, documents and other evidence. As mentioned earlier, the Finance Act, 1975 introduced Section 44B in the Income Tax Act providing for determination of the profite and gains of shipping business in the case of non-residents by applying a fixed percentage of 7.5 per cent to the earnings by way of freight, carriage of passengers, mail, livestock, etc., at Indian ports. This was done to eliminate difficult and complicated issues arising in the assessments of non-resident shipping companies, particularly in relation to depreciation, the balancing charge or allowance and the apportionment of overhead expenses[1/].

73. The Finance Act, 1976 carried the process of rationalisation and simplification of assessments of non-residents further by providing for the levy of tax at fixed rates on the gross earnings by way of dividends, royalty and technical fees, by fixing a ceiling for claims in

1/ Memorandum Explaining the Provisions of the Finance Bill, 1975, Para.48.

respect of head office expenses and by enacting a clear-cut source rule for such receipts. The Finance Act, 1983 has further extended the scope of the simplified procedure to interest on foreign currency loans advanced to the Government or an Indian concern.

74. Another area where the simplified procedure could be usefully extended is the taxation of the profits of air transport in the case of non-residents. The problems here are more or less similar to those involved in the taxation of shipping profits and there seems to be no reason why a similar procedure should not be applied in their cases also. The trend in other countries is also to adopt such a standardised procedure for computing income arising from air transport. By falling in line, India would be eliminating several problems that now arise in giving effect to double tax avoidance agreements or to the provisions giving unilateral relief. The bilateral agreements generally provide that income derived from the operations of aircraft in international traffic shall be taxed only by the home country. Simplification as suggested above is therefore not likely to give rise to any serious hardship to the air companies or cause any serious detriment to the revenue.

75. The taxation of dividends, certain kinds of interest, royalty and technical fees at standard rates on the gross receipts without allowing any deduction for expenses within or outside India is also conceived as a measure of simplification. The standard rates have been set lower so as to compen-

sate for the non-deduction of expenses. It has to be examined whether these rates are fair and reasonable in the context of the intended role that foreign companies are expected to play in the Indian economic scene.

h. Dividends

76. Dividends are taxable at the rate of 25 per cent on the gross amount without allowing any deduction for expenses, under Section 115A(a) of the Income Tax Act. Before the insertion of Section 115A by the Finance Act, 1976, dividends received by a foreign company were entitled to a deduction of 65 per cent under Section 80M of the Income Tax Act which applied to both domestic and foreign companies. For domestic companies the deduction was lower being 60 per cent only. This was apart from the deduction for expenses which could be allowed under Section 57(i) of the Income Tax Act. The basic tax rate applicable to a widely-held domestic company and a foreign company being 55 per cent and 70 per cent, respectively, this would have meant that a wisely-held Indian company was being taxed on its net dividend income at 22 per cent and a foreign company at 24.50 per cent, surcharge apart in both the cases. Foreign equity participation in Indian companies is strictly regulated by guidelines issued under the FERA and allowed only when it is in the interest, of the economy. Such equity participation is likely to save the country valuable foreign exchange. Once that is so, there seems no ground for taxing the dividends received by a foreign company from an Indian company more heavily than dividends received by their Indian counterparts.

After the insertion of Section 115A the disparity in effective tax rates has widened as Indian companies can continue to claim deduction for expenses under Section 57(i), while a foreign company is taxed at 25 per cent on the gross amount.

77. Under the newly inserted Section 115E of the Income Tax Act, the investment income of a non-resident Indian (which inter alia would include dividends) will be taxed at 22.5 per cent (including surcharge). This has been done with a view to improving the investment climate in India for non-residents. Many non-resident Indians might find it more convenient to invest through companies floated by them outside India, but then, the result would be that such a company will have to pay more by way of tax in India apart from the tax that the company will have to pay in the home country. Besides this, there seems to be no reason why foreign companies who have been permitted to participate in the equity of Indian companies should be taxed at 25 per cent on their gross income from dividends. There appears to be ample justification for reducing the rate to, say 20 per cent.

i. Interest income

78. Interest received by a foreign company from the Indian Government or any Indian concern on foreign currency loans is also taxed at a flat rate of 25 per cent from 1.6.1983. This concession is apart from the total exemption granted under Section 10(15)(iv) in respect of interest on certain foreign currency

loans, etc., Technically, dividend income has always received a more favourable tax treatment than interest. While there may be no need for any change in the rate of 25 per cent applicable to certain types of interest income of foreign companies, this would provide an added justification for reducing the tax rate on dividend income as suggested above.

j. Royalties

79. Realising the importance of foreign technology for the development of Indian industries, the tax rate on the income of a foreign company from royalties and technical fees received from the Indian Government or from an Indian concern under an approved agreement was reduced in the fifties by granting a super tax rebate on such income. When super tax was integrated with income tax, the tax rate on such income was fixed at 50 per cent. Under the simplified procedure introduced in 1976 for taxing such income on gross receipts basis, the tax rate was reduced to 40 per cent (20 per cent in the case of certain lump-sum payments which would be discussed later). The reduction in rate was in lieu of expenses to the equivalent of 20 per cent of the gross receipts. For setting at rest the controversies raging at that time on the situs of accrual of royalty and technical fees (and hence their taxability in India in the case of a non-resident recipient) the law was amended to provide specifically at to what type of payments would be deemed to accrue or arise in India (see para 71). Another common point of dispute used to be whether a payment was of income

or capital nature in the hands of the receipent. The amendment also sought to provide a more clear-cut test in this behalf by roping in lump-sum payments but excluding amounts which would be chargeable under the head 'capital gains'.

80. When the above reforms were brought in it was also considered desirable to have the term 'royalty' and 'fees for technical services' defined the law itself. Accordingly, explanation 2 below Clause (vi) of Section 9(i) defined 'royalty' in the following terms.

> <u>Explanation 2</u>
>
> For the purposes of this clause "royalty" means consideration (including any lump-sum consideration but excluding any consideration which would be the income of the recipient chargeable under the head "Capital gains") for:
>
> i. the transfer of all or any rights (including the granting of a licence) in respect of a patent, invention, model design, secret formula or process or trade mark of similar property;
>
> ii. the imparting of any information concerning the working of, or the use of a patent, invention, model, design, secret formula or process or trade mark or similar property;
>
> iii. the use of any patent, invention, model, design, secret formula or process or trade mark or similar property;
>
> iv. the imparting of any information concerning technical, industrial, commercial or scientific knowledge, experience or skill;

payments may be regarded either as royalty or as fees for technical services. As the tax treatment differs in regard to lump-sum payments, this overlapping is a potential source of disputes and litigation. That apart, the definition of 'royalty' seems to depart from the commercial concept of royalty.

81. The Gujarat High Court had occasion to examine the commercial concept of royalty in CIT vs Ahmedabad Manufacturing and Calico Printing Co. /(1983) 139 ITR 806/. In that case the assessee entered into an agreement on August 28, 1961, with a foreign company. Under the terms of the agreement, the assessee was given the exclusive right of licence to manufacture, distribute, sell and exploit the products and improvements, modifications thereof in India and use of any Indian patents owned or to be owned by the foreign company in respect of the said products. Where the foreign company was the proprietor of a trade mark registered in India which was used in relation to the said products, the assessee was to be granted the benefit of registration as the exclusive registered user of such trade mark. Under the agreement, the assessee was to preserve the secret processes and not to part with the knowledge of these secret processess to any one else. Under the agreement, the assessee agreed to pay to the foreign company, one per cent of the net sale proceeds of the products mentioned in the agreement which the assessee could manufacture. This amount was to be paid as "research contribution". No other fee or remuneration was payable to the foreign company under the agreement. The payment agreed to be made to the foreign company was tax-free, that is, the tax chargeable on the

v. the transfer of all or any rights (including the granting of a licence) in respect of any copyright, literary, artistic or scientific work including films or video tapes for use in connection with television or tapes for use in connection with radio broadcasting, but not including consideration for the sale, distribution or exhibition of cinematographic films; or

vi. the rendering of any services in connection with the activities referred to in sub-clause (i) to (v)".

Similarly, explanation 2 below clause (vii) defines 'fees for technical services' as below:

"<u>Explanation 2</u>

For the purposes of this clause, "fees for technical services" means any consideration (including any lump-sum consideration) for the rendering of any managerial, technical or consultancy services (including the provision of services of technical or other personnel) but does not include consideration for any construction, assembly, mining or like project undertaken by the recipient or consideration which would be income of the recipient chargeable under the head 'salaries')".

One thing that strikes even the layman's eye is that the two definitions overlap. It is very difficult to regard consideration for "imparting information" /clause (ii) or (iv) of Explanation 2 to Section 9(i)(vi)/ and for rendering of services /Clause (vi) of the said explanation/ as 'royalty'. It would better fit the description 'fees for technical services'. In any case, the definition of 'fees for technical services' /Explanation 2 to Section 9(1)(vii)/ does not exclude such payments. The result is that certain kinds of payments was to be borne by the assessee. The Income Tax Officer worked out the gross contribution at Rs.1,62,330 and determined tax at 70 per cent thereof at Rs. 1,13,632. The assessee contended that the rate at which tax was deductible on the remittances, made in accordance with the provisions of Section 195 of the 1961 Act, read with the Finance (No.2) Act, 1971, was 50 per cent because the payments made were "royalties". The Income Tax Officer held that the payment was research contribution and as such, fell to be treated as residuary income taxable at the rate of 70 per cent and not as royalty taxable at 50 per cent. The Appelate Assistant Commissioner affirmed the order of the ITO. On further appeal, the Tribunal held that, having regard the agreement, the payments were royalty payments and as such were liable to deduction at source at the lower rate of 50 per cent. On a reference, the Gujarat High Court held, that, firstly, the agreement between the assessee and the foreign company was for a period of 10 years only. Secondly, it was in respect of certain secret or patent formulations owned or controlled by the foreign company. The payment, though called "research contribution" in the agreement, was nothing but the consideration correlated to the extent of the exploitation of the secret formulations and patent rights and various other rights belonging to the foreign company by the assessee in India and that it was for the exclusive right to manufacture the products that the payment was made and it was nothing else but "royalty" as known to law and to the international commercial world in the context of such agreements. The High Court, therefore, held that the Tribunal was right in holding that the payment made by the assessee to the foreign company during the relevant period was royalty payment and was liable to deduction of tax at the lower rate of 50 per cent as prescribed in the Finance (No.2) Act, 1971. In coming to the conclusion that the 'research contribution' in the instant case amounted to 'royalty' as known to law, the Court kept in view various commercial definitions of the term such as:

i. <u>"In Corpus Juris Secundum", Vol.17 at p.542</u>.

"Defined generally, the world 'royalty' means a share of the product or profit reserved by the owner for permitting another to use the property; the share of the production or profit paid to the owner; a share of the product or proceeds therefrom reserved to the owner for permitting another to use the property; the share of the produce reserved to the owner for permitting another to exploit and use the property; a share of the profit, reserved by the owner for permitting another to use the property; the amount reserved or the rental to be paid the original owner of the whole estate".

ii. <u>"Words and Phrases Legally Defined", Vol.4 at p. 354</u>

"Royalty' (except in the expression' 'tonnage royalty') includes a dead rent and any periodical or other payment for minerals got under a mining lease, and 'tonnage royalty' means a royalty calculated by reference to the amount of minerals so got from time to time, or of manufactured articles produced from such minerals, or by any similar method".

iii. <u>"Encyclopaedia Britannica", 1972, Edn., Vo.19 p. 676.</u>

"The payment made to the owners of certain types of rights by those who are permitted by the owners to exercise the rights; the rights concerned are literary, musical and artistic copyright, rights in inventions and designs, and rights in mineral deposits, including oil and natural gas. The term originated from the fact that in Great Britain for centures gold and silver mines were the property of the Crown; such 'royal' metals could be mined only if a payment 'royalty' were made to the Crown... An individual inventor without capital or plant must licence others to manufacture his invention. When owners of rights make arrangements for such exploitation by others, the remuneration they receive in exchange is often in the form of a royalty, usually based on the actual extent of the exploitation".

In the light of the above commercial usages it is very difficult to regard consideration for rendering services as 'royalty' as has been done in the definition of 'royalty' in explanation 2 to Section 9(i)(vi) of the Income Tax Act.

82. The definition of 'royalty' in India's double tax avoidance agreements more closely approximate to the commercial concept. For example, para 3 of Article XIII of the agreement with UK (1981) defined 'royalty' as under:

"The term 'royalties' as used in this Article means payment of any kind including rentals received as a consideration for the use of, or the right to use:

i. any patent, trademark, design or model, plan, secret formula or process;

ii. industrial, commercial or scientific equipment, or information concerning industrial, commercial or scientific experience;

iii. any copyright of literary, artistic or scientific work, cinematographic films, and films or tapes for radio or television, broadcasting;

> but does not include royalties or other amounts paid in respect of the operation of mines or quarries or of the extraction or removal of natural resources".

The definition in para 3 of Article XIII of the agreement with Tanzania (also 1981) is in substance more or less the same though the phraseology is different and reads as:

> "The term 'royalties' as used in this Article means payments of any kind received as a consideration for the use of or the right to use, any copyright of literary, artistic or scientific work (including cinematography films, and films or tapes for radio or television broadcasting), any patent, trade mark design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial or scientific equipment, or for information concerning industrial, commercial or scientific experience".

The definitions of 'royalty' in the agreements with several other countries are on similar lines. Interpretation of law mainly hinges on the words used. Even the intention of the legislature is to be gathered from the words used and not from the records of Parliamentary debates. The need to employ similar phraseology while dealing with similar situations, therefore, assumes great importance. If at all it is considered necessary to define the term 'royalty' in the Income Tax Act, it would be necessary to keep in view the commercial sense of the term and also ensure uniformity of wording in the Act and in various tax agreements. As of now, a payment might fit in the description of royalty as per the definition in the Act but yet not fall within the definition in a tax agreement; there could then be genuine difficulties in giving effect to the double tax avoidance agreement in regard to the payment.

83. The more important question is, however, whether there is any need to distinguish between 'royalty' and 'fees for technical services' on the one hand and lump-sum payments and recurring payments on the other. Foreign collaboration agreements usually contemplate the following types of payments to the foreign collaborators:

i. initial lump-sum for the transfer of rights in any technology or imparting of information;

ii. royalty;

iii. fees for technical services;

iv. dividends on shares allotted to the foreign participants either in lieu of technical know-how services or otherwise;

v. payment for supply of machinery and/or other equipment; and

vi. payment of interest on money lent and/or outstanding balance for supply of machinery, etc.

Of the above, items (iv) and (vi) are easily and separately identifiable. Item (v) also cannot be ordinarily confused with the other types of payment. Further, the supply of machinery usually takes place at arms length and no profit can be imputed to the transaction as arising to the non-resident in India. Because of this there could be a temptation to inflate the cost of machinery and correspondingly reduce the taxable payments. Similarly, in the case of export-oriented industries where the foreign collaborator gets also involved in the export operations, he might accept a larger commission on exports outside India which would be non-taxable, in lieu of lower royalties and technical fees which are taxable. These would be matters for investigation in individual cases and the problem cannot be dealt with by purely legislative measures. But considerable confusion seems to prevail over items (i) to (iii). The collaboration agreements may not always segregate these payments and may stipulate only a single payment as the total consideration. In such a situation, controversies arise as to the break-up of the consideration into its component parts. A uniform tax treatment would eliminate the need for the break-up and thus do away with controversies.

84. As mentioned earlier, a lower rate of tax applies in the case of certain lump-sum payments of royalty (and not lump-sum payments of fees for technical services). The term 'lump-sum' has not been defined in the Income Tax Act as such. However, while defining the term 'royalty' (explanation 2 to Section 9'1)(vi), it has been specifically provided that royalty includes any lump-sum consideration. Therefore, it can be inferred that the lump-sum consideration is only a form of royalty, the

only difference being that, whereas royalty is generally a recurrent feature based on production or sales, lump-sum payment is a predetermined amount payable by the Indian counter-part under a collaboration agreement, irrespective of production or sale. Although an initial lump-sum payment is in the nature of royalty, there is a difference in rates of tax for royalty and for lump-sum consideration. Section 115A of the Income Tax Act provides that in the case of a foreign company, any lump-sum received by it for the transfer outside India of, or the imparting of information outside India in respect of, any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process or trade mark or similar property, the rate of income-tax will be 20 per cent of the gross lump-sum payment. The balance of royalty is taxable at the rate of 40 per cent. It should be noted that the lower rate of tax (20 per cent instead of 40 per cent) on a lump-sum consideration is applicable only when the technical know-how, and information relating to it, is imparted outside India. If the know-how is transferred in India, the rate of tax would be 40 per cent. It is not difficult for the parties to a collaboration agreement to arrange the transaction in such a way as to make it appear that the transfer of the know-how or imparting of information takes place outside India when that enables them to get the benefit of a lower tax rate. In any event, this could easily become a hot bed of controversies. Once lump-sum payments are made taxable and tax jurisdiction assumed it seems quite unnecessary to make this refinement based on the situs of the transfer. A uniform rate would obviate the need for such a distinction.

85. The law, however, does not make all lump-sum payments taxable Consideration which would be taxable as the income of the recepient chargeable under the head 'capital gains' has been specifically excluded from the definition of 'royalty' in Explanation 2 below Section 9(1)(vi). From the language in which the exception is couched, the intention is not quite clear. A plain reading of the provision would lead one to assume that, if a lump-sum payment is not chargeable to tax in India under the head 'capital gain' it would be chargeable as 'royalty'. In other words, a lump-sum payment is char able to tax under all circumstances, either as capital gain or as royalty. This interpretation would however be irrational as a receipt cannot be regarded as 'royalty' unless it has the characteristics of income. The definition only deems the place of accrual. It does not further deem a capital receipt to be a revenue receipt. A lump-sum payment which is in the nature of a capital receipt cannot be charged to tax in India unless any part of it becomes chargeable under the head 'capital gains'. Under the present law as interpreted in judicial decisions, a capital receipt can become chargeable under the head 'capital gains' only if the following three conditions are satisfied, namely;

i. it must arise from the transfer of a 'capital asset' as defined in Section 2(14) of the Income Tax Act; secondly,

ii. the asset must be one which has a cost of acquisition; in other words, self-generated assets would not give rise to liability to capital gains tax when transferred; and thirdly,

iii. the gain must accrue or arise in India or must be deemed to accrue or arise in India, this condition would be satisfied only when the capital asset is situate in India.

In must cases, technical know-how even when regarded as a transferable capital asset, would be of the self-generated variety. Further, if the transfer takes place outside India the gain cannot even otherwise be taxed. The law does envisage a capital receipt not being chargeable either as capital gain or as income. Thus, although a flat rate of tax has been prescribed under Section 115A, for taxing the initial lump-sum, it must be exphasized that such consideration is taxable only if it is in the nature of 'revenue' Where it could be proved that the receipt in question is not a revenue-receipt, it should be possible to argue that it would not constitute income under the Income Tax Act and no tax would be chargeable on it. Generally, if a transaction is in the assessee's ordinarly line of business, the receipt from it would be 'revenue' in nature because it would be regarded as a trading receipt. But where the transaction is outside the assessee's line of business, it is to be considered upon the facts and circumstances of each case, as to whether the receipt is in the nature of 'revenue' or 'capital'. If the owner of the technical know-how gets a lump-sum payment for imparting the know-how to others, without substantially reducing its value for himself (although it may get diluted by being communicated to others), the receipt would ordinarily be taxable as income on the ground that the exploitation of the know-how is in the course of business and imparting it is no more than a business service of a special kind[1]. On the other hand, where the know-how is imparted in circumstances which substantially diminish its value to the owner, e.g., where it is imparted as one element of a comperhensive arrangement by virtue of which a trader effectively gives up his business in a particular area, the money paid for the know-how properly rank as a capital receipt[2]. When a person trades in the know-how, it is a revenue receipt, but when the disposes of or parts with it pro-tanto, it will be a capital receipt. Further, the qualification "excluding any consideration which would be the income of the receipient chargeable under the head 'capital gains'" seems to apply only to lump-sum payments and not to periodical payments. It is common knowledge that even the consideration for transfer of a capital asset may not be paid as a 'lump-sum' but may be paid in instalments over a period of time. Thus, it does not seem to be the intention of the law that consideration in the nature of capitals receipt should be treated as royalty merely because it is not actually liable to capital gains tax in

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1/ See Hindustan Forests Co Ltd vs CIT (1966) 60 ITR 470 (Punj); Evans Medical Supplies Ltd vs Moriarty (1959) 35 ITR 707 (HL) Rolls-Royce Ltd vs Jeffrrey 40 TC 443 (HL) and CIT vs Cilage Ltd (1968) 70 ITR 760 (Bom).

2/ See Evans Medical Supplies Ltd., (1959) 35 ITR 707 (HL) Wolf Electric Tools Ltd vs Wilson 45 TC 326.

India or because it is not paid as a lump-sum. The language used in the definition of 'royalty' does not seem to bring out the legislative intention. What should really have been excluded from the definition of 'royalty' would be 'consideration for the transfer of a capital asset'. If the transfer of the capital asset takes place outside India, it would be totally exempt from tax; if the transfer takes place in India there would be liability to capital gains tax; and if the consideration does not relate to the transfer of a capital asset it would be charged to tax as royalty whether the transaction takes place outside India or in India. In the last case, there does not seem to be any justification for applying differential tax rates depending on whether the transaction takes place outside India or within India.

86. Except in regard to lump-sum payments, royalties and fees for technical services are treated alike for tax purposes. In either case, the tax rate is 40 per cent and that is applied to the gross receipt without allowing any deduction. Once the tax differential in respect of lump-sum payments is eliminated, it would pave the way for a uniform tax treatment of royalties and technical service fees which would considerably simplify assessments in foreign collaboration cases.

87. That leads us to the question whether there is justification for taxing royalties and fees for technical services on gross basis without allowing any deduction for expenses. Conceived as a simpli-

fication measure, this procedures was introduced by the Finance Act 1976 in view of the practical difficulties in determining the net income in such cases'[1]. In regard to income from dividend or interest or, to some extent even royalty, it can be argued that the income content of the gross receipt in practically 100 per cent and the prohibition on the deduction of expenses should not work any real hardship on the non-resident assessee. This argument would not however hold good in the case of 'fees for technical services' for earning which the non-resident has to depute his technical experts to work with his Indian counterpart and he has to incur expenditure on them. The bar against deduction of expenses does create real hardship in such cases. The way the term royalty has been defined, similar hardship would arise in the case of certain 'royalty' payments also. The non-resident can, however, avoid the mischief of the provision by shifting the entire burden of meeting the remuneration and expenses of his technical staff to the Indian collaborator and the effect of the provision is only to push up the cost of foreign collaboration for the Indian industries. While it is understandable that there would be difficulties in checking expenditure incurred outside India and in determining the proportionate share of head office expenses, there should be really no problem in verifying expenses incurred within India. From an equity point of view also, it appears to be unreasonable to disallow expenses incurred in India which would in many cases attract tax in the hands

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1/ Memorandum Explaining the Provisions of the Finance Bill, 1976 - Para 34.

of the recipients. As a measure of simplification and rationalisation it would be desirable to tax the entire consideration payable to a non-resident under an approved collaboration agreement with a resident (except the consideration for the transfer of a capital asset) as income arising to the non-resident in India and charge it to tax at a uniform rate of, say, 40-50 per cent after deducting all expenses incurred and disbursed in India wholly and exclusively in connection with the collaboration without making any attempt to dissect the consideration as lump-sum and others or as royalty and fees for technical services.

k. Other incomes - need for reduction in tax rate

88. The controversies relating to the taxation of the income of non-resident companies from sources other than dividend, interest, royalty and technical fees are as problematic, particularly as the stakes are high, the tax rate being as high as 73.5 per cent. Firstly, the departmental officers are often inclined to treat even payments made under approved collaboration agreements as not being royalty or fees for technical services and apply the rate of 70 per cent plus surcharge as was done in the case of the 'research contribution' paid to the foreign collaborator in the Calico case (See para 81 ante). It is to meet this type of unpredictable burden that foreign collaborators often make their Indian counterpart bear their tax liability in India. The result is that the country stands to lose and not gain.

89. Another undesirable effect of the stiff rates of tax applicable to foreign companies is that they are often tempted to salvage their income by claiming large expenses. The principle of taxing gross receipts applicable to dividends, certain types of interest, royalties and fees for technical services does not apply to other income. While claims for deduction of head office expenses have been regulated by Section 44C inserted in 1976, the expenses in India are not in any way limited except to the extent of the usual limitations on entertainment, salaries and perks, etc., which apply to all assessees resident or non-resident. As expenses relatable to earning of dividends, certain types of interest, royalties and fees for technical services are totally disallowed, there could be a tendency to shift the burden of those expenses to other income and thereby not only make up for the disallowance but also gain something more because of the steep rate differential. This would in fact be an added reason why expenses incurred in India for earning royalties and technical fees are better allowed to be set off against such income which bear a lower rate of tax.

90. The Tables I.5 and I.6 show that foreign companies account for a gross demand of much less than Rs 100 crore. If the normal gap between the gross demand and net collectible demand arising from disputed assessments is taken into account, foreign companies cannot be regarded as a substantial source of revenue. Only a part of this demand would relate to income to which the 70 per cent plus surcharge rate applies. A sample study of 100 foreign tax cases assessed at Bombay during the financial year 1982-83 shows some interesting results which are presented in the following Tables:

TABLE V.2

Distribution of Foreign Company Assessments According to Activity

Activity	Number of assessments	Gross income assessed (Rupees)	Gross income assessed (Per cent)	Total income assessed (Rupees)	Total income assessed (Per cent)	Gross tax payable (Rupees)	Gross tax payable (Per cent)	Average tax rate
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Banking	9	349621765	53.16	348567700	53.54	259563223	64.37	74.47
Industry	2	13078280	1.99	13078280	2.01	9142358	2.27	69.90
Tech-consultancy	25	97276293	14.79	96748729	14.86	52484818	13.02	54.25
Investment	45	157093228	23.89	152049164	23.36	52219642	12.95	34.34
Air lines	4	8536200	1.30	8535200	1.31	6274107	1.55	73.50
Others	13	32064488	4.88	32054487	4.92	23562064	5.84	73.51
TOTAL	100	657670255	100.00	651034560	100.00	403245212	100.00	61.94

Source: Information collected in the course of the Study.

TABLE V. 3

Distribution of Foreign Company Assessments According to Gross Income Range

Income range	Number	Gross-in-assessed (Rs)	Total income assessed (Rs)	Gross tax payable (Rs)	Average tax rate (Rs
(1)	(2)	(3)	(4)	(5)	(6)
Upto 1 lakh	20	721736	695358	303885	43.70
1 - 5 lakh	16	3740952	3721951	1615101	43.39
5 - 10 lakh	12	7887190	7884050	2732397	34.65
10 - 25 lakh	20	32487245	31332181	13355869	42.63
25 - 50 lakh	8	27597629	27543043	9140241	33.19
50 - 100 lakh	10	75635985	74515935	30855771	41.41
Above 100 lakh	14	509599518	505342042	345242948	68.32
TOTAL	100	657670255	651034560	403245212	61.94

Source: Same as for Table V.2.

TABLE V.4

<u>Distribution of Foreign Companies by Activity and Income Range</u>

Range/Activity	Upto 1 lakh	1-5 lakh	5-10 lakh	10-25 lakh	25-50 lakh	50-100 lakh	Above 100 lakh	Total
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Banking (number)	1	0	0	0	0	1	7	9
per cent	(11.00)	(0.00)	(0.00)	(0.00)	(0.00)	(11.11)	(77.78)	(100.00)
Industry (number)	0	0	0	1	0	0	1	2
per cent	(0.00)	(0.00)	(0.00)	(50.00)	(0.00)	(0.00)	(50.00)	(100.00)
Tech-consultancy (number)	1	6	3	10	1	3	2	26
per cent	(3.85)	(23.08)	(11.54)	(38.46)	(3.85)	(11.54)	(7.69)	(100.00)
Investment (number)	11	7	7	8	6	5	2	46
per cent	(23.91)	(15.22)	(15.22)	(17.39)	(13.04)	(10.87)	(4.35)	(100.00)
Air lines (number)	2	0	0	1	0	1	0	4
per cent	(50.00)	(0.00)	(0.00)	(25.00)	(0.00)	(25.00)	(0.00)	(100.00)
Others (number)	6	3	1	0	1	0	2	13
per cent	(46.15)	(23.08)	(7.69)	(0.00)	(7.69)	(0.00)	(15.38)	(100.00)
TOTAL (number)	21	16	11	20	8	10	14	100
per cent	(21.00)	(16.00)	(11.00)	(20.00)	(8.00)	(10.00)	(14.00)	(100.00)

Source: Same as for Table V.2.

TABLE V.5

Distribution of Foreign Companies by Activity and Income Range

Range/Activity	Upto 1 lakh	1-5 lakh	5-10 lakh	10-25 lakh	25-50 lakh	50-100 lakh	Above 100 lakh	Total
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Banking (number)	1	0	0	0	0	1	7	9
per cent	(4.76)	(0.00)	(0.00)	(0.00)	(0.00)	(10.00)	(50.00)	(9.00)
Industry (number)	0	0	0	1	0	0	1	2
per cent	(0.00)	(0.00)	(0.00)	(5.00)	(0.00)	(0.00)	(7.14)	(2.00)
Tech-consultancy (number)	1	6	8	10	1	3	2	26
per cent	(4.76)	(37.50)	(27.27)	(50.00)	(12.50)	(30.00)	(14.29)	(26.00)
Investment (number)	11	7	7	8	6	5	2	45
per cent	(52.38)	(43.75)	(63.64)	(40.00)	(75.00)	(50.00)	(14.29)	(46.00)
Air lines (number)	2	0	0	1	0	1	0	4
per cent	(9.52)	(0.00)	(0.00)	(5.00)	(0.00)	(10.00)	(0.00)	(4.00)
Others (number)	6	3	1	0	1	0	2	13
per cent	(28.57)	(18.75)	(9.09)	(0.00)	(12.50)	(0.00)	(14.29)	(13.00)
TOTAL (number)	21	16	11	20	8	10	14	100
per cent	(100.00)	(100.00)	(100.00)	(100.00)	(100.00)	(100.00)	(100.00)	(100.00)

Source: Same as for Table V.2.

It may be seen that, out of the 100 companies, a vast majority, namely, 72, are companies deriving their income mainly from dividends, royalties and fees for technical services which are taxable at special lower rates. Of the 26 companies which suffered tax at an average rate of more than 70 per cent, 9 are foreign banks and 4 foreign air lines. The remaining 13 contributed only slightly over 5 per cent to the total tax demand against all the 100 companies. Even out of these 13, some have interest income which is probably covered by the reduced tax rate brought in by the Finance Act, 1983. Some others might have been controversial cases like the Calico case where the 70 per cent tax rate may not be sustained in appeal. Air lines account for less than 1 per cent of the demand. It can, therefore, be safely assumed that the entire brunt of the high tax rate on the residuary income of foreign companies falls on the handful of foreign banks operating in India. In terms of income they form the most important segment of the foreign companies accounting for 53 per cent of the total income assessed and 64 per cent of the tax demand in the sample. The problem of high tax rates on foreign companies has therefore to be viewed primarily from the angle of the foreign banks operating in India.

1. Banking industry

91. The foreign companies which had established industries in India have by and large indianised themselves by transferring their business to Indian subsidiaries in accordance with the policy of the Indian Government in this behalf. The foreign holdings in these subsidiaries are also being progressively diluted in accordance with the guidelines issued under the FERA

from time to time. These companies are Indian companies under the Income Tax Act. As regards foreign companies collaborating with Indian industries, the bulk of their income arises from royalties, fees for technical fees, dividends and interest which are taxed at special lower rates of tax, a discussion on which appears earlier in this Report. The residuary rate of 70 per cent plus surcharge does not substantially affect them as would be seen from Tables V.2 to V.5

92. The foreign banks have been allowed to operate in India under licence. As mentioned earlier, it is a conscious decision of the Government that the foreign banks should operate in India through branches rather than through subsidiaries so that their global assets would provide a better security for the depositors. There is also a certain amount of reciprocity in permitting foreign banks to operate in India as Indian banks are simultaneously allowed to open branches outside India. It might be argued that the high residuary rate of tax applicable to foreign companies is aimed at discouraging them from carrying on activities which are not in the interests of the country's economy. This reasoning can not however apply to foreign banks which have been permitted to operate in India through branches as they have a useful role to play in our economy and, as mentioned earlier, do not hold out any threat to the Indian banking industry. They carry on their activities in a form desired and approved by the Government of India and one finds it difficult to justify the heavy tax burden imposed on them. Some of the foreign banks which operate in India operate in other countries through subsidiaries rather than through branches because they have been allowed to be so. Having made it a policy to

allow foreign banks to operate in India through branches and not subsidiaries it seems to be unfair to penalise them by a high rate of tax. The tax burden is even higher than that the statutory rate suggests on account of statutory disallowance of executive remuneration, etc. Security of service in foreign banks is highly suspectible to Government policies and it becomes necessary for them to offer better emoluments and other conditions of service than their Indian counterparts. Unlike other industries, banking does not enjoy any substantial tax concessions under our law. As discussed in paragraphs 58 to 60 above, foreign banks have a useful role to play in our economy and they seem to hold out no threat to the Indian banking industry. As the foreign banks operating in India are by and large, broad-based corporations in their own home countries, it seems appropriate that they should be equated with widely-held Indian companies for the purpose of tax rate. This seems to be all the more necessary when branches of Indian banks are taxed at much lower rates in other countries as the following Table would show:

TABLE V.6

Rate of Tax Applicable in Selected Foreign Countries to the Foreign Branch Income of Indian Banks

Name of country	Rate of tax (per cent)
Belgium	54.49
Dubai	20
Fiji	40
Guyana	55
Hong Kong	17
Kenya	52.5
Korea	Graded rates from 10 to 40
Malaysia	40
Mauritius	55
Singapore	40
Seychelles	35
Sri Lanka	66

Source: Information furnished by some Indian Banks having overseas branches.

It is, therefore, necessary to bring down the tax rate applicable to the business income of foreign banks licensed to operate in India to the level of the rates applicable to a widely-held Indian company.

We may add here that the high tax rate now applicable to foreign banks does not seems to the result of a conscious decision on the part of Government to keep the rate on them very high, while reducing the rates applicable to foreign companies deriving many other kinds of income. Rather, the high rate has survived because the matter has simply not received attention. The Government has done right an allowing the foreign banks to continue to function; hence our recommendation for a reasonable rate of tax.

93. The foreign air lines operating in Indian also stand on a similar footing. They are here because of reciprocal arrangements with other countries. A measure of parity is needed in the matter of tax rates here also. A suggestion has been made earlier in this Report that the profits of foreign air lines should be assessed on a summary basis and the tax should be levied as a percentage of their earnings in India as in the case of shipping. Once that is done it would be hardly justifiable to have a high rate of tax. It is therefore suggested that the income of foreign air transport companies should also be brought down as in the case of banks. The revenue effect of this would be, as seen from Tables V.2 to V.5 very negligible.

94. As brought out by Tables V.2 to V.5, foreign companies not engaged in investment, technical consultancy, air transport, or banking contribute only a negligible amount to the revenue. The rate of 70 per cent plus surcharge applicable to the residuary income of foreign companies serves hardly any fiscal purpose but might in fact be counter-productive by making evasion and avoidance more remunerative or by proliferating disputes and litigation. It cannot serve any economic or social purpose either. There are other laws through which the operations of foreign companies are regulated to be in tune with the national aspirations for development and self-sufficiency and a high tax rate is a poor tool to serve that purpose. It opens up the way for adverse comparisons and could be a powerful disincentive for international participation in the economic development of our country. As shown in Chapter IV, this type of discrimination against foreign companies does not exist in most developed countries and not even in many

developing countries. At worst, where differential tax treatment is given to closely-held and widely-held domestic companies, foreign companies are equated with closely-held domestic companies. There is, therefore, urgent need to bring down the residuary rate of tax applicable to other foreign companies to the level of that applying to closely-held domestic companies in India, namely, 65 per cent plus surcharge. One justification that is often given for a higher tax rate on foreign companies than applicable to domestic companies is that the dividends distributed by the foreign company outside India do not suffer any tax in India. The fallacy in this line of reasoning is that the non-resident shareholder of a foreign company is not taxed on his dividend income because both he and the source of his income are outside the tax jurisdiction of the country. The profits earned in India having been fully taxed in the hands of the company, there would be little justification for taxing the dividends distributed outside India in the hands of a non-resident shareholder directly or indirectly by charging a higher tax on the company itself. The general principle adopted in the double tax agreements in respect of taxation of dividend income is that the tax jurisdiction should be exclusively with the source country where the company has its seat of management and the dividends are declared. It would then be difficult to justify the levy of a higher rate of tax on the Indian income of a foreign company on the ground that the dividends declared by the company outside India do not bear any tax in India. In fact, even in regard to resident corporations, there is increasing realisation of the need to provide relief against the double taxation of both the income of the company and the dividends coming out of the taxed profits in the hands of the shareholders. Shareholders of an

Indian company who are individuals or HUFs are exempted from tax in respect of their income from dividends upto an aggregate of Rs 7,000 taken along with the income from certain other financial assets (Section 80L). Intercorporate dividends are totally exempted if the dividends are derived from companies engaged in specified industries and partially so in other cases (Section 80M).

95. The above conclusions have been reached on the assumption that the rates of tax applicable to Indian companies remain at their present levels. There is a general feeling that companies in India are too heavily taxed. In the present study, the case for a general lowering of the corporate tax rates has not been examined. Such a study would not be realistic unless the impact of the various exemptions and reliefs which the direct tax laws in Indian provide is also examined. A lowering of rate of tax on companies together with the withdrawal of a number of reliefs and concessions may indeed be desirable. However, the rationale behind the conclusion reached in this study that for the purpose of tax rates the business income of foreign banks and air transport companies should be equated with widely-held Indian companies and the residuary income of other foreign companies should be taxed at rates applicable to a closely-held Indian company, would still remain even if there is a lowering of the tax rates on Indian companies.

m. Allowance of head office expenses

96. In the assessment of non-resident companies operating in India through branches or other permanent establishments, the law imposes a limitation on the deduction of head office expenses in Section 44C

inserted by the Finance Act, 1976. The scope of this limitation has been discussed earlier. In the context of the difficulties in the verification of head office expenses and linking them with the Indian business and in view of the natural tendency to shift a higher proportion of the head office expenses to jurisdictions where the tax rates are higher, the limitation cannot be said to be unreasonable. As discussed in Chapter IV the practice in this behalf varies from country to country and no objection could possibly be taken to India adopting a procedure best suited to its administration. The data collected in the course of the present study do not contain any thing to indicate that the absolute ceiling of 5 per cent of the adjusted total income imposed under Section 44C is in any way unreasonable. No change in this regard is therefore suggested.

n. Surtax on companies

97. The surtax on companies has been criticised as a tax on efficiency and its imposition has been adversely commented upon in various forums. The justification for this tax has not been gone into in this study, but no purpose seems to be served by making foreign companies theoretically liable to surtax. In practice, the foreign banks seems to be not affected by it. In the case of other foreign companies collaborating with Indian industries, interest, royalties, and fees for technical services received from the Government or a local authority or an Indian concern and dividends from Indian companies already stand excluded from the chargeable profits. The law also empowers[1/] the Government to exempt

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1/ Section 24AA of the Companies (Profits) Surtax Act inserted with effect from 1.4.1981.

from surtax foreign companies participating in the business of prospecting for, or extraction, etc. of, mineral oils. The operations of foreign companies are regulated by other measures and it seems unnecessary to resort to the mechanism of imposing a tax on their "super-profits". There are practical difficulties in determining their capital base for determining the statutory deduction for arriving at the profits chargeable to surtax. It would considerably clear up the atmosphere for foreign participation in our industrial development without the sacrifice of any appreciable revenue and without impinging on the basic rationale behind the levy of surtax if foreign companies as such are placed outside the purview of the Companies (Profits) Surtax Act.

o. <u>Surtax on the foreign income of domestic companies</u>

98. The recent trend is for Indian concerns to go trans-national. They are encouraged to pertake in joint ventures abroad; and to export not only goods but also projects, technical know-how and services. Income tax concession are allowed in respect of such exports.[1/] When tax relief on exports used to be allowed under the Finance Acts in the early and mid-sixties, the export profits relief was being excluded from the chargeable profits for surtax. With the accent on exports and building up our foreign exchange reserves, there seems to be no justification for including in the surtax base of Indian companies their foreign income which is duly brought into India, or retained abroad for approved purposes

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1/ Section 80HHB - Deduction of profits and gains from projects outside India.

Section 80HHC - Deduction in respect of export turnover.

Section 80N - Deduction in respect of dividends received from certain foreign companies.

Section 80O - Deduction in respect of royalties, etc., from certain foreign enterprises.

p. Surtax on Indian banks

99. Similarly, there seems to be no justification for levying surtax on Indian banking companies. It may be that some of them, because of their large reserves or provisions treated as reserves, do not attract liability to surtax. But cases have arisen where surtax has been levied on banks. In fact, some of the nationalised banks subjected to surtax seem to have challenged the levy on the ground that the bank nationalisation law deemed them to be companies for purposes of income tax only and not for surtax. The interest rates on moneys lent by the banks as also the interest allowed by them to the depositors are both regulated by the Government through the RBI. Their investments are also similarly regulated. There seems to be no rationale behind subjecting them to surtax when their profit making apparatus is regulated in this manner. When companies were liable to the wealth tax during the years 1957-58, 1958-59 and 1959-60, banking companies were specifically exempted from that tax.1/ Banking companies, if any of them are closely-held, will now be exempt from the revived levy of wealth tax on closely-held companies2/ under this provision. It is desirable that banking companies should, in a similar fashion, be specifically exempted from the levy of surtax as well.

q. Some administrative issues

100. By and large, the Income Tax Act in India provides a common code of administrative procedures applicable to both residents and non-residents and to domestic as well

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1/ Section 45(a) of the Wealth Tax Act, 1957.

2/ Section 40 of the Finance Act, 1983.

as foreign incomes. While no attempt has been made in this study to assessee the effectiveness of these procedures and identify source of irritation a few problems areas did come to be noticed in the course of the study. As some hardship arises to the taxpayers having transnational income on account of these, a mention is made of them in this report.

i. <u>Exercise of powers to enforce furnishing of information</u>

101. The Income Tax Act contains a wide variety of provisions empowering the tax authorities to enforce attendance and production of original documents, accounts and other evidence. Foreign companies have, understandably, difficulties in complying with these requisitions where they relate to their head office expenses. Some assessing officers seem to be taking an unduly narrow view of the legal requirements for the verification of the income received by the taxpayers and verification of their claims for deduction of expenses, reliefs, etc. Of course, no hard and fast rules can be laid down in this behalf and a large measure of discretion has necessarily to rest with the assessing authority in deciding whether he would be content with internal documentation only or he should requisition external documentation and audit certification or he should launch on a full-fledged investigation and call for all types of original documents, books of account and other evidence. Having regard to the economic and political angles involved and keeping in view the fact that while dealing with transnational income these must get precedence over purely revenue and legal considerations, great circumspection and restraint seems to be called for in handling such cases. In the metropolitan cities where most of such

cases are concentrated, special foreign tax circles have been created and senior and experienced officers posted to man them. This would by itself in a large measure provide a safeguard against excessive or irresponsible exercise of the administrative powers. Still, a word of caution from the Central Board of Direct Taxes to their officers against unreasonable demands for information and supporting documents seems to be necessary. Ordinarily, the assessing authority should rely on internal documentation only. Asking for external documents and certification should be the exception rather than the rule. Full-fledged investigation calling for original papers should be reserved to clear areas of evasion or violation of the law and that too with the explicit approval of the highest administrative authority. Even here, to the extent possible, assistance from the counterparts in the other country should be sought. With the recent trend of incorporating in the bilateral tax treaties clauses facilitating exchange of information and assistance in investigation and tax recovery, this might be a more fruitful approach. Some of the nationalised banks covered by this study also expressed concern over the tendency on the part of some officers to call for minute details of expenses incurred abroad as well as locally and to disallow them when such details are not furnished within the short time allowed to them. Banks have thousands of branches spread over the nocks and concerns of this vast country and a number of them have overseas branches as well. As mentioned by the of one bank officials, the total expenses on an innocuous item like "broom sticks and cleaning materials" could total upto several lakhs of rupees for all the branches taken together. Considerable expenditure has to be incurred by sending telex, telephonic and telegraphic messages to the branches for collecting the information sought by the assessing authority. Here again, some instructions to the field staff from the highest administrative authority seems to be necessary.

ii. <u>Grant of double tax relief</u>

102. Indian companies having foreign income seem to be having difficulties in securing double tax relief at the hands of the tax authorities whether on the basis of bilateral conventions for avoidance of double tax or on the basis of the unilateral relief provisions in our Income Tax Act. Even some of the nationalised banks have pointed out that there is considerable delay in getting the appropriate relief from the Indian tax authorities. Unilateral relief under Section 91 is allowable when tax has been paid in the other country by <u>deduction or otherwise</u> on the double taxed income. Yet, some assessing officers seem to be insisting on production of assessment orders, tax paid challans and finality certificates from their counterparts in the other country before allowing the relief. It has been pointed out that the assessment procedures differ from country to country and some do not issue formal assessment orders or finality certificates. In many countries the Inland Revenue Authorities accept tax computation statements filed by the auditors and evidence of payment of tax by deduction or otherwise, while retaining a right to check the accuracy of the claims at any time. Some instructions to the field officers to allow double tax relief at least provisionally reserving a right to rectify, without insisting on final assessment orders or other finality certificates seem to be necessary.

103. Even with regard to the countries with whom double tax avoidance agreements are in force, some assessing officers seem to be taxing the foreign incomes also notwithstanding the agreements and allowing relief only in the same way as in the case of unilateral relief. This procedure makes the double tax avoidance agreement

meaningless. Here again, the field officers need to be instructed to allow the relief in accordance with the terms of the agreements at the time of making the assessment initially. It is hardly necessary to point out that the delay in granting double tax relief, results in locking up of the assessees' funds with consequent loss of interest. The law does not provide for payment of interest on the delayed refund, except with refunds have been determined but not actually issued for a period exceeding three months. It is strongly argued that officers assigned to deal with large undertakings with transnational incomes be given special training and be made properly conscious of helping the country's efforts to earn foreign exchange.

iii. Interest on delayed refund of tax deducted at source

104. That takes us to another problem which seems particularly acute in the case of banks. The banks have a large volume of income from interest on securities from which tax is deducted at source. Many of the nationalised banks pay excess tax by deduction at source and have to wait for more than 2 years for getting it refunded after final assessment, which adversely affects their liquidity. Whereas there is a provision in the law (Section 214) for grant of interest on excess advance tax paid, there is no similar provision for grant of interest on excess tax deducted at source except in the limited case of a person having income from interest on securities and dividends only [Section 243(i)(a)]. The law seems to discriminate between two types of pre-assessment tax-payments which it is hard to justify. It would be desirable to amend the law to ser right this anomaly. In the

meanwhile, administrative instructions seems to be necessary for expediting grant for refund on provisional basis under the existing law (Section 141A).

iv. Instalments of advance tax

105. According to statutory requirements, banks have to close their accounts on 31 December each year. They have no choice in the matter as other companies have. Under the existing law, they have to pay the third and final instalment of advance tax on 15 December. With a large number of farflung branches and branches in foreign countries, banks seems to be having genuine difficulties in making proper estimates of advance tax by the last date stipulated. The law empowers the Board[1/] having regard to the nature of dealings in the business carried on by the assessees the method of accounting followed by them and other relevant factors, to authorise by notification in the Official Gazette and subject to such conditions as may be specified therein, the payment of the last instalment of advance tax on the 15 March instead of 15 December. It appears that such a notification has been issued in the case of insurance business. It seems desirable that a similar notification should be issued in the case of Indian banking business as well.

v. Allocating interest paid against dividend income

106. Another practice which seems to be hitting the banks hard and generating litigation is the tendency on the part of some of the assessing officers to allocate a

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1/ Proviso to Section 211(1) of the Income Tax Act, 1961.

part of the interest paid out by them against dividend income, which tends to reduce or even wipe off an item of income which is taxable at a concessional rate.[1/] Banks do not borrow funds for acquiring shares of companies. It seems to be unrealistic to allocate any portion of the interest paid out against dividend income unless there is something to show that the shares were acquired specifically out of borrowed funds. Here again, some administrative instructions are called for.

vi. Administrative delay in granting approval

107. Another difficulty faced by banks having overseas branches results from the delay in granting approval under Section 36(1)(viiia) of the Income Tax Act. This provision, which was introduced by the Finance Act, 1982 enables an Indian scheduled bank having banking operations outside India to deduct, in computing its taxable income, any amount (not exceeding 40 per cent of the gross total income) carried to a special reserve, provided the bank is for the time being approved by the Central government for the purpose. It has been mentioned that, though more than a year has passed after the provision was inserted in the law, no approvals have so far been granted. In the meanwhile, to be on the safer side, the banks have created the necessary reserve but are not in a position to take advantage of the deduction for payment of advance tax, self-assessment tax, etc., in the absence of the necessary approval from the Central government. Most of these banks are in the State sector and there is little justification for keeping them in a State of suspense. Some early action in this behalf seems to be necessary.

1/ Section 80M allows a 60 per cent deduction from divided in the case of a domestic company. In the case of a foreign company, dividends are taxed at the rate of 25 per cent.

vii. Creation of special reserve

108. The provision relating to the creation of special reserve has given rise to some practical difficulties in working out the ceiling of 40 per cent with reference to the total income before making any deduction under Chapter VIA of the Income Tax Act (i.e., the gross total income). The gross total income itself is to be worked out after deducting the amount transferred to the reserve under Section 36(1)(viiia). This means that a mathematical formula will have to be evolved for determining the ceiling. In Section 23(2) of the Income Tax Act where the annual value of a self-occupied house has to be restricted to 10 per cent of the gross total income, the need for a mathematical formula has been avoided by providing that, in computing the gross total income, the income from the self-occupied house should be excluded. In Section 36(1)(viiia) also the working of the ceiling could have been made simple by providing that the gross total income for the purpose should be worked out before making the deduction under the provision. An amendment in this behalf seems to be called for.

viii. Provision for bad debts

109. By an amendment made by the Finance Act, 1979[1/] a deduction is allowed in the case of all scheduled commercial banks in respect of provision made for bad and doubtful debts relating to advances made by their rural branches subject to a ceiling of 1.5 per cent of the aggregate of such advances. The Finance Act, 1982 has extended the benefit to non-scheduled commercial banks as

1/ Clause (viia) inserted in Section 36(1) of the Income Tax Act, 1961.

well. There seems to be,need to extend a similar benefit to advances made by overseas branches also particularly when the assessing officers insist on strict proof of the debt having become bad which it is difficult to provide in the case of overseas transactions. The special reserve referred to in an earlier paragraph is meant for financing expansion and not meant to serve as a cushion against doubtful debts.

110. In the matter of normal provisions for bad and doubtful debts of banks, a liberal policy used to be followed in the past. The present practice is, however, to require the bank to establish that the debt had become 'bad' during the accounting year and that the debt is written off in the bankIs books. Many assessing officers seem to take the narrow view that write off means crediting the debtors' account and closing it. This the banks are not always in a position to do. Secondly, assessing officers seem to be demanding strict proof even in regard to petty amounts. When the major banks are in the State sector, such an approach seems to be wholly unproductive and wasteful and proliferates litigation. After all, there are provisions in the law for bringing to tax bad debts subsequently realised when they have been allowed to be deducted in an earlier year. Some executive instructions to the field staff in this behalf seems to be necessary. A large part of the bad debts of the nationalised banks is a legacy of the pre-nationalised period and a pragmatic approach in this regard is necessary.

VI. SOME WIDER ISSUES

111. In the foregoing Chapters, various issues concerning taxation of transnational income of companies in India have been examined. This has been done primarily keeping the following in view:

i. changed attitudes in India in the 80's, along with avowed Government intentions of encouraging and promoting foreign investments, to update technology, as well as modernise, so as to render competitive, the Indian industrial sector, and the need to supplement this liberal attitude to 'foreigners' by simplifying and rationalising the existing tax provisions/rates which relate to non-residents, and to align them more to international practices;

ii. the radically changed economic situation due to continuing large deficits in the balance of payments, projected in the medium term, requiring urgent attention on all fronts connected with the management of the external sector of the economy; and

iii. the increasing interdependence of the global economies which require standardisation of accounting, taxation and trade practices to facilitate cross border movements of goods and services.

The conclusions reached and the suggestions made in this Report have to be viewed in this context.

112. This is, however, not to say that there are no other issues having a bearing on the problem. The first of these is that the activities of a few giant multinational corporations all over the globe have created certain prejudices and suspicions in the minds, particularly, of the third world countries. Our Prime Minister in her address to the Non-aligned Nations Conference at

Algiers on 6.9.1973 referred to the activities of the faceless multinational corporations as very vehement, unscrupulous and sometimes quite subtle.[1/] Multinational corporations have sometimes been described as a 'State within a State'. The United Nations considered it necessary to establish a 'Group of Eminent Persons' to study the impact of multinational corporations on the development process and on international relations.[2/] The report of the Group focussed pointed attention to the effects of the activities of the multinational corporations in the various national jurisdictions.[3/] Dr. V. Gauri Shankar, after exhaustively analysing the various issues posed by the operations of transnational corporations, has suggested the setting up of an International Control Agency for TNGs under the aegis of the U.N. for implementing a code of conduct for them.[4/] The point that emerges from his analysis is that the issues are far too complex and the possible remedies far too intricate to make the income tax law a suitable weapon for 'taming the giants'. Whether an alien corporation should be allowed to operate on its soil or not and, if so allowed, within what perimeters, is a conscious political decision to be taken by a country.

1/ Government of India, Publications Division (1973).

2/ Unesco resolution 1721 (L 111) of 28 July, 1972.

3/ U.N. December E/5500/Revi ST/ESA.6 "The Impact of Multinational Corporations on Development and International Relations, New York, 1974, p. 25.

4/ Dr. V. Gauri Shankar, Taming the Giants - Transnational Corporations in World Arena, p. 211.

But once foreign companies are permitted to operate in Indian within well demarcated boundries by a conscious decision based on an appraisal of the developmental needs of the country and the need for reciprocity, it looks unfair that they should be subjected to a discriminatory rate of tax or subjected to other harsh procedures. If they don't behave, there are other ways of disciplining them.

113 There have also been severe criticisms of the manner of functioning of and allegations of tax evasion against some of the foreign companies operating in India. A few of them have also figured in the Reports of the Public Accounts Committee of Parliament. However, a harsh tax treatment to foreign companies operating in India cannot be justified on the ground that some of them evade tax. In fact, the high rates of tax on their incomes in India themselves constitute a contributory factor to tax evasion by making tax evasion mere profitable. A reduction in the rates will reduce the incentive for tax evasion. In his budget speech for 1980-81, the Finance Minister observed:

> "The reduction in rates and other concessions in respect of direct taxes should ordinarily involve loss of revenue. However, I am of the view that reduction in rates will lead to significantly improved compliance with tax laws. The legislative amendments made for countering tax avoidance devices and the changes in the provisions in regard to advance tax should result in large accretion of revenue".

The Finance Minister was obviously deriving strength fr m the past experience when the revenue realisations increased after the maximum marginal rate for non-corporate income tax had been slashed down from 97.75 per cent to 77 per cent and then to 66 per cent. There are ample procedures under the tax laws to deal with tax evasion. In addition, there are special provisions in the Income Tax Act for dealing with tax avoidance by residents acting in concert with non-residents (Sections 92 and 93). If necessary, these provisions can be further strengthened. In any event, tax evasion is a much wider issue and should not be allowed to cloud decisions on the limited problems relating to the taxation of non-residents dealt with in this Report.

VII. SUMMARY OF OBSERVATIONS AND SUGGESTIONS

114. A summary of the important observations and suggestions made in the foregoing Chapters is given below:

I. Introduction

1. Foreign companies have an important role to play in our economy. However, neither in terms of number nor in terms of revenue can they be regarded as a major constituent of the taxpayers in India. Their operations are also strictly regulated by law. The taxation policy in regard to foreign companies has, therefore, to be shaped not by purely revenue considerations but in the broader perspective of the country's economic policies and development programmes.

(Paras 1-9)

II. Evolution of the Corporate Tax Law In India

2. The corporate tax rates in India have generally tended to rise steadily in the post-independence era. There has also been considerable experimentation in the field of corporate taxation and taxation of dividends.

(Paras 10-16)

III. Taxation of Foreign Companies and Foreign Income of Indian Companies

3. Before independence, Indian companies and foreign companies were practically treated alike except that, while resident companies were required to pay tax on

their world-wide income, the non-resident companies were taxed only on their income from sources in British India.

(Para 17)

4. In the pre-independence days, the rules regarding accrual of income were considerably influenced by the existence of a large number of princely States which were not part of British India or later the 'taxable territories' but were nevertheless an integral part of India in regard to commerce and trade. The concepts of 'domestic company' and 'Indian company' came to be incorporated in the law only after independence. This led to the development of three different, though often overlapping, concepts namely (a) resident and non-resident companies, (b) Indian and non-Indian companies, and (c) domestic and foreign companies.

(Paras 18 and 19)

5. It was only after independence that foreign companies came to be subjected to a higher rate of income tax than domestic companies. In the early stages, a rate differential existed between closely-held and widely-held foreign companies. This distinction was given up later. Lower rates of tax came to be adopted in regard to the income of a foreign company from dividend, royalty and fees for technical services (later extended to interest on certain foreign currency loans) in the context of the need for encouraging foreign investment and technical collaboration selectively. The rate of tax on the residuary income of foreign companies has, however, almost steadily risen and stands at 73.5 per cent today.

(Paras 20 and 22)

6. In an attempt to simplify the assessment of non-residents and in view of the difficulties in verifying their claims for expenses, the law has been amended from time to time. Thus, non-resident shipping companies are taxed on the basis of a fixed percentage of their turnover. Income from dividends, royalties, fees for technical services and interest on certain foreign currency loans have been made taxable on gross receipts basis without deduction of expenses. In other cases a ceiling on the deduction for head office charges has come to be imposed. Certain clear-cut source rules have also been incorporated in the law itself.

(Paras 23-28)

7. The provisions relating to bilateral agreements with other countries have been made more broad based and agreements have been entered into with a number of countries for avoidance of double tax,for exchange of information and for assistance in investigation and tax recovery.

(Paras 31-33)

Treatment of Non-Resident Corporations in Other Countries

8. The corporate tax rates in India, particularly, those applicable to non-resident companies, are very much higher than what obtain in most other countries. The administrative procedures in other countries are also, by and large, more pragmatic and less burdensome.

(Paras 34-55)

V. Some Problems and Possible Remedies

9. A newly independent country like India has necessarily to pass through various phases in its attitude to foreign investment. India has moved from the 'dependence' phase to the 'independence phase' and is moving into the 'inter-dependence phase'. The attitudes towards foreign investment and technology have in recent times undergone a visible change. The tax laws, however, do not seem to have kept pace with this change.

(Paras 56-57)

10. The liberal approach is also evident in the policy towards foreign banking. At the time of nationalisation, they were consciously kept out as it was recognised that they had an important role to play in the economy. There is increasing realisation that foreign banks have a contribution to make in areas of international loans, syndications and investments. They also help the Indian banking system in its process of transnationalisation, innovation and modernisation. Foreign banks, however, do not constitute any threat to the Indian banking industry and there seems to be no need for a protectionist policy in the matter of taxation.

(Paras 58 to 61)

11. The independent definitions of 'company' under the different direct tax laws need to be replaced by a common definition.

(Para 62)

12. The multi-fold classification of companies as (a) resident and non-resident, (b) Indian and non-Indian, and (c) domestic and foreign, should be done away with the replaced by a single categorisation, say, domestic and foreign as in most other countries. The classification should be uniform for all economic laws.

(Paras 63-66)

13. The independent provisions in the Income Tax Act and Wealth Tax Act for the declaration of a non-resident association as a 'company' could lead to anomalies and difficulties and should be replaced by a common provision.

(Para 67)

14. The classification of companies as closely-held and widely-held, though no longer relevant in the case of foreign companies for the purpose of tax rates and the levy of an additional income tax for non-distribution or inadequate distribution of dividends, continues to be relevant in relation to set-off of earlier years' losses. Section 79 of the Income Tax Act denying the right of set-off when there has been a substantial change in the shareholding has been critisized even in its application to Indian companies. The theoretical possibility of the provisions being invoked against foreign companies should be removed by restricting the provision to Indian companies only.

(Para 69)

15. The source rule based on the vague concept of 'business connection' is a hang-over from the past and should be done away with.

(Paras 70-71)

16. In recent years, there has been an attempt to simplify the assessment of non-residents. Non-resident shipping companies are now to be taxed by treating a fixed percentage of their gross earnings in India as their income. This procedure could be usefully extended to air transport companies as seem to have been done in certain other countries.

(Para 74)

17. The tax rate on the gross dividend income of a foreign company from Indian companies may be lowered to, say, 20 per cent.

(Paras 76-77)

18. While the tax rate on certain types of interest income may remain at 25 per cent as laid down from 1.6.1982, this would provide added justification for lowering the tax rate on dividends.

(Para 78)

19. The definition of 'royalty' and 'fees for technical services' overlap. The definition of 'royalty' is also not in tune with the commercial concept of royalty and the definitions of the term in various tax treaties. The differential tax rate in respect of 'lump-sum' payments of royalty based on the situs of the transfer of know-how creates difficulties and

is open to manipulations. In practice, it is also difficult to analyse the composite consideration stipulated in a collaboration agreement as royalty, fees for technical services, lump-sum payments and so on. The entire consideration payable on the basis of an approved a collaboration agreement (excluding clear-cut items like dividends, interest, payment for supply of equipment, etc.), should be taxed at a uniform rate.

(Paras 79-74-86)

20. The exclusion from liability to be treated as royalty of payments 'chargeable under the head capital gains' creates controversies and difficulties in interpretation. The exclusion should be of amounts representing the consideration for transfer of a capital asset. If the capital asset is situate in India, the surplus would be taxable as capital gain. If outside, no tax would be leviable.

(Para 85)

21. For rendering technical services, the non-resident has to deploy his experts in India. Such expenses are now disallowed. The non-resident can find an easy way out by making the resident collaborator bear these charges. While there may be difficulties in verifying claims for expenses incurred outside India, there seems to be no reason why expenses incurred in India should not be allowed. Payments under an approved technical collaboration agreement should, therefore, be taxed on the net amount after allowing deduction for expenses incurred within India, at a rate of, say, 40 to 50 per cent.

(Para 87)

22. Taxing the residuary income of foreign companies at the high rate of 73.5 per cent seems to be wholly unjustifiable when the operations of foreign companies in India are strictly regulated by other laws. There is no rationale in having this type of punitive tax rate which is made more so by statutory disallowance of expenses actually incurred (e.g., remuneration and perks to executives entertainment expenses, etc.).

(Paras 88-90)

23. The residuary rate falls heavily on foreign banks having branches in India. Foreign banks have a distinct role in our economy and they supplement and not compete with the Indian banking industry. They operate through branches and not through local subsidiaries (as they do in other countries) not by choice but in view of the Government's policy. The foreign banks operating in India are broad-based companies in their own home countries. Foreign branches of Indian banks are taxed at much lower rates in other countries. The tax rate applicable to the business income of a foreign bank should, therefore, be the same as the rate applicable to a widely-held domestic company.

(Paras 91-92)

24. Similarly, the tax rate applicable to foreign air transport companies for which a simplified assessment procedure has been suggested elsewhere, should also be brought down as in the case of foreign banks.

(Para 93)

25. The tax rate applicable to the residuary income of foreign companies other than banks and air transport companies should be the same as applying to a closely-held domestic company.

(Para 94)

26. The corporate tax rates in India have been frequently criticized as excessive in comparison with the rates in other countries. The above formula of equating the rate of tax on foreign banks and air lines to the rate applicable to widely-held domestic companies and the rate of tax on the residuary income of other foreign companies with the rate applicable to closely-held domestic companies would remain valid even if there is a general reduction in the corporate tax rates on domestic companies.

(Para 95)

27. In the context of the difficulties in the verification of head office expenses and linking them with the Indian business, it is not unreasonable to limit their deduction by a statutory ceiling.

(Para 96)

28. Surtax on companies has been criticized as a tax on efficiency. In the case of foreign companies its operation gives rise to various practical difficulties. As the activities of foreign companies in India are regulated by other measures, it seems unnecessary to have a tax on their super profits.

(Para 97)

29. In the mid-sixties, the export profit relief allowed used to be excluded from the surtax base. In the context of the need to encourage export of not only goods but also of projects, technical know-how and services, it is desirable to exclude the foreign income of domestic companies from the surtax base.

(Para 98)

30. The profit making apparatus of banking companies is regulated by law. The major Indian banks are in the State sector. When wealth tax was leviable on companies (now it has been revived in the case of certain assets of closell—held companies), banking companies were specifically exempted. Similarly, banking companies should be specifically exempted from surtax as well.

(Para 99)

31. Certain administrative procedures also need to be stream lined for relieving hardship to taxpayers having transnational income.

(Para 100)

32. Calling for external documentation and minute details in respect of foreign income and expenses should be the exception and not the rule. By and large, the officers should rely only on internal documentation and not insist on production of originals. Similarly, in the assessment of banks having a large number of branches all over India and outside, the assessing officers should refrain from calling for detailed break-up of expenses, etc.

(Para 101)

33. There appears to be considerable delay in the grant of double tax relief resulting in the hold-up of refunds due to the taxpayers for long periods without the benefit of getting interest. Some instructions to the field officers to allow the relief at least provisionally without insisting on finality certificates seem to be necessary.

(Para 102)

34. Even in regard to countries with which double tax avoidance agreements are in force, the assessing officers seem to be taxing the foreign income in the first instance and insisting on finality certificate before allowing the relief. This makes the double tax avoidance agreements meaningless. Here again, some instructions to the field staff seem to be necessary.

(Para 103)

35. Banks pay excess tax by deduction at source and are often made to wait for more than 2 years to get the refund, and that too without interest. The law needs to be amended to provide for payment of interest on delayed refund of tax deducted at source in the same way as in the case of advance tax. The provisions of Section 243 of the Income Tax Act are not adequate as they do not apply to assessees having business income. In the meanwhile, instructions may be issued to the field officers to grant the refunds provisionally.

(Para 104)

36. Like insurance companies, banks may also be allowed to pay the last instalment of advance tax on 15 March, and not on 15 December. They have to close their accounts on 31 December not by choice but by statutory compulsion. With farflung branches and branches in foreign countries, they find it difficult to estimate their incomes correctly by 15 December.

(Para 105)

37. The practice of allocating a part of the interest paid by banks against their dividend income causes hardship and generates litigation. Administrative instructions seem to be necessary to restrict the practice only to cases where the shares have been clearly acquired out of borrowed funds.

(Para 106)

38. No approvals seem to have so far been granted under Section 36(1) (viia) of the Income Tax Act authorising Indian banks to create tax deductible services out of their foreign branch income even though the provision was inserted in the law by the Finance Act, 1982. This puts the banks in a State of uncertainty. Some early action in this behalf seems to be necessary.

(Para 108)

39. The benefit of deducting bad debt reserve upto a statutory maximum which is now restricted to the advances made by rural branches of banks may be extended to advances made by their foreign branches as well.

(Para 109)

40. In the matter of allowance of other bad debts, particularly, in the case of the nationalised banks, a more liberal and pragmatic approach seems to be necessary.

(Para 110)

VI. Some Wider Issues

41. There are no doubt certain wider issues relating to the role of multi-nationals and the need to keep their activities strictly within bounds. There have also been allegations of tax evasion against some foreign companies. These are independent issues to be dealt with as such. They should not be allowed to cloud a decision on the suggestions made in this Report relating to the tax treatment of the income of foreign companies arising from legitimate activities within the spheres marked out for them, having due regard to our developmental needs.

(Paras 111-113)

Tax Rates on Companies

(Including Surcharge where Applicable)

Assess-ment year	Domestic Widely-held companies: Small	Domestic Widely-held companies: Others: Indus-trial	Domestic Widely-held companies: Others: Non-indus-trial	Domestic Closely-held companies: Industrial	Domestic Closely-held companies: Non-indus-trial	Non-domestic	
(1)	(2)	(3)	(4)	(5)	(6)	(7)	
1957-58 to 1959-60	46.50	51.50	51.50	51.50	51.50	40.00	on dividend from subsidiary
						60.00	on residuary income
1960-61 and 1961-62	40.00	45.00	45.00	45.00	45.00	30.00 to 53.00	on different types of dividends
						45.00	on royalties from Indian concerns under approved agreement
						63.00	on residuary income
1962-63 and 1963-64	45.00	50.00	50.00	50.00	50.00	30.00 to 45.00	on different types of dividends
						50.00	on royalties from Indian concerns under approved agreements
						63.00	on residuary income
1964-65	42.50	45.00	50.00	54.00	60.00	50.00	on royalties and technical fees from Indian concerns under approved agreements
						65.00	on residuary income

(1)	(2)	(3)	(4)	(5)	
1965-66	42.50	45.00	50.00	Upto 10 lakhs	45.00
				Above 10 lakhs	54.00
1966-67 to 1968-69	45.00	55.00	55.00	Upto 10 lakhs	55.00
				Above 10 lakhs	60.00
1969-70 to 1971-72	45.00	55.00	55.00	Upto 10 lakhs	55.00
				Above 10 lakhs	60.00
1972-73	46.125	56.375	56.375	Upto 10 lakhs	56.375
				Above 10 lakhs	61.50
1973-74	47.25	57.75	57.75	Upto 10 lakhs	57.75
				Above 10 lakhs	63.00
1974-75	47.25	57.75	57.75	Upto 2 lakhs	57.75
				Above 2 lakhs	63.00

Annexure A (Contd.)

(6)	(7)	
60.00	As for 1964-65	
65.00	50.00	on royalties and technical fees from Indian concerns under approved agreements
	70.00	on residuary income
65.00	As for 1966-67	
66.625	51.25	on royalties and technical fees from Indian concerns under approved agreements
	71.75	on residuary income
68.25	52.50	on royalties and technical fees from Indian concerns under approved agreements
	73.50	on residuary income
68.25	As for 1973-74	
		From 1977-78 special provisions for dividends and for royalties and technical fees from Indian concerns under approved agreements to the taxed on gross receipts basis at the following rates
	25.00	dividends
	20.00	Lump-sum royalty for transfer of know-how outside India

(1)	(2)	(3)	(4)	(5)	(6)
1980-81 and 1981-82	48.375	59.125	59.125	Upto 2 lakhs 59.125 Above 2 lakhs 64.50	69.50
1982-83 and 1983-84	46.125	56.375	56.375	Upto 10 lakhs 56.375 Above 10 lakhs 61.50	66.625
1984-85	57.75	57.75	57.75	63.00	68.25

Annexure A (Contd.)

	(7)
40.00	other royalties and technical fees.
25.00	dividends
20.00	lump-sum royalty for transfer of know-how outside India from Indian concerns under approved agreements
40.00	other royalties and technical fees from Indian concerns under approved agreements
75.25	residuary income
25.00	dividends
20.00	lump-sum royalty trr transfer of know-how outside India from Indian concerns under approved agreements
40.00	other royalties and technical fees from Indian concerns under approved agreements
71.75	residuary income
25.00	dividends
25.00	interest on foreign currency loans
20.00	lump-sum royalty for transfer of know-how outside India received from Government or from Indian concerns under approved agreements
40.00	other royalties and technical fees from Government or from Indian concerns under approved agreements
73.50	residuary income.

Notes:

1. Wealth tax was leviable on the net wealth of companies for the assessment years 1957-58 to 1959-60. The levy of wealth tax on certain assets of closely-held companies has been revived from assessment year 1984-85.
2. Super-profit tax on companies was levied for the assessment year 1963-64 and replaced by Surtax from 1964-65.
3. For some years during the late fifties and sixties an additional tax (by way of withdrawal of rebate) was leviable on excess dividends and issue of bonus shares.
4. After the abolition of surcharge in 1960-61 a 2½ surcharge was re-introduced in 1972-73 which was raised to 5 per cent in 1973-74 and to 7½ per cent in 1980-81. It was reduced to 2½ per cent in 1982-83 only to be raised again to 5 per cent in 1984-85 with a provision for a 2½ per cent relief when the requisite deposit is made with the IDBI.

Annexure B

List of Countries with which India has Bilateral Agreements for Avoidance/Relief of Double Tax

Comprehensive agreements	Restricted agreements
Austria	Afghanistan (aircraft)
Belgium	Bulgaria (shipping)
Ceylon	Czechoslovakia (shipping)
Denmark	Ethiopia (aircraft)
Finland	German Democratic Republic (shipping)
France	Iran (aircraft)
Federal Republic of, Germany	Italy (aircraft)
Greece	Lebanon (aircraft)
Japan	Romania (aircraft & shipping)
Malaysia	Switzerland (aircraft)
Norway	U.S.S.R. (shipping)
Singapore	U.S.A. (aircraft)
Libya	
Sweden	
Tanzania	
U.A.R.	
U.K.	