

## CHAPTER X

### TAXATION OF FOREIGN COMPANIES IN INDIA

As in other underdeveloped countries, in India too the Government had and has to depend for finances on native as well as foreign investors. The contribution of private investors from overseas in helping the growth of India's industries is quite substantial. The foreign investment has flown into India mostly through the big financial institutions or foreign companies. These foreign investors, most of whom are companies, while deciding to invest their funds in India, naturally take into account the tax incidence in this country. They compare the relative tax burden in their own country and in other foreign countries with that in India, before deciding about the magnitude and geographical distribution of their investments abroad.

Not that taxation alone is a guiding factor for foreign investors who also take into account political and other economic factors. But, taxation serves one important purpose of encouraging or discouraging (as the case may be) the flow of foreign investments, since taxation directly affects the profits of the investors. Hence, a study of the tax problems confronting the foreign companies functioning in India becomes an important one. It has become more important since the

beginning of India's Five Year Plans under which considerable attention has been given to the problems involved in encouraging foreign investment in India.

Generally, foreign companies function through Indian branches or through subsidiary companies incorporated in India, the whole or the major portion of whose shares is held by the foreign companies. A "foreign controlled company" is designated as a "branch" when it has a foreign incorporation. Companies with Indian registry i.e. rupee companies, may be broadly grouped into "subsidiaries" and other controlled companies. A company is regarded as a subsidiary when a foreign company is known to exercise majority control over its ordinary shares or Board of Directors. Other controlled companies are those in which foreign control is presumed to exist on the basis of certain prima facie considerations. A minority shareholding company may come under the third group.

A "foreign company" has nowhere been defined in the Indian Income Tax Act. Hence, in common parlance, a foreign company might imply any of the following connotations:-

- (1) A non-Indian company.
- (2) A non-resident company
- (3) A company which is not a company within the meaning of the Indian companies Act of 1956.

- (4) A company incorporated outside India whose registered office is not situated in the taxable territory of India.

However, for the purposes of the Income tax Act, a foreign company cannot be treated as a company, unless,

- (a) it is or was assessable as a company for the assessment year 1947-48; or
- (b) it is declared by general or special order of the Central Board of Revenue to be a company.

From the point of view of Income taxation, one may call a "foreign company", only that company, which has not made the effective arrangements for declaration and payment of dividends in India; and a "non-foreign" company, only that company, which has made such effective arrangements in India. This distinction is more reliable, since the tax liability of a foreign company depends on whether it has or has not made the effective arrangements for declaration and payment of dividends in India.

It would be interesting to remember that before 1958, "income criterion" was adopted to determine the residence of the companies. According to the income criterion, a company was considered resident in India in any year if its income arising in India in that year exceeded its income arising abroad. The implication of a company being resident is that it is

liable to Indian taxes on the whole of its world income. But, this criterion proved to be a deterrent to foreign investment. Therefore, the Finance Act, 1958, deleted this condition and retained the other criterion according to which a company is resident if the control and management of its affairs is situated wholly in India. The Act has also provided that all companies incorporated in India will be treated as resident companies, even if in any case the control and management is shifted outside India.

In so far as the foreign companies have been taking active part in the trade and industry of the country, it would be useful to survey briefly their growth and role. In chapter II, while describing the growth and role of corporations in India, it has been already pointed out that the foreign investors had played an important part in the development of India's transport, trade, industry and banking. At the end of 1913, there were 579 foreign companies with a total paid-up capital and debentures amounting to Rs. 389 crores. After 1921, their number increased to 678 with a total paid-up capital and debentures to the tune of Rs. 907 crores which is more than double the figure in 1913. At the time of the beginning of the Second World War i.e. in 1939, the total number of companies registered outside India but having a place of business in India was 870 with a total paid-up

capital (including debentures) of Rs.1138 crores. Since then the number of companies has shown a distinct tendency to decline. Their number during 1939 and 1949 varied between 822 and 870 and the variation in their paid-up capital and debentures taken together ranged between Rs.1058 crores and Rs.1138 crores. The number of companies stood at 822 with a total paid-up capital and debentures of Rs.1255 crores on 31st March, 1954.

Though, continuous data about foreign companies for the two Plan period, are not available in all details, from the data published by the Reserve Bank of India (Reserve Bank Bulletin, January, 1960, page 13) and by the Department of Company Law Administration (The Corporate Sector in India, by Raj and Chaudhari, pages 51-52), it may be mentioned that the number of foreign companies declined from 882 in 1953-54 to 562 in 1959-60. This number stood at 561 in 1957-58 and 572 in 1958-59. It seems the commonwealth countries represented about 77 percent of the total number of foreign companies at work as on 31st March, 1960.

As regards the industrial pattern of the foreign companies, it may be stated that before the World War I, by and large an overwhelming section of these companies devoted itself to banking and insurance, transport, trade, plantations and mining. This type of industrial pattern remained unaltered

upto 1919. But, during the inter-war period, the foreign companies also took up extraction of petrol. During the post-Independence period i.e. after 1947, foreign companies showed a marked decline in the railways which were then nationalised. Whereas, the petroleum mining witnessed some increase both in number and paid-up capital.

It has been already pointed out in chapter II that investments through foreign companies have played a significant part in the initial as well as the higher stages of India's economic development. Although the number of such foreign companies in India has declined, when compared with the total number of companies incorporated in India depending exclusively on the domestic investors, the financial resources available to these foreign companies and their earning capacity, are quite out of proportion to their numerical strength.

Therefore, the problem of the incidence of taxation on the income of the foreign companies in India is of great interest and importance to a foreign investor, as it is to a domestic investor. This is of particular interest for all those foreign companies which have alternative opportunities in other countries too. Since they have to make a choice between different countries for investment, they generally calculate the comparative tax advantage likely to accrue

to their investments. Obviously, a simple and clear picture of what a foreign investor should expect to pay and save under the existing tax system of India would certainly help him in deciding about the volume and type of investment. For this ~~purpose~~ purpose, a foreign investor would naturally take into account two things: (1) the tax rate i.e. the rate at which tax will be calculated with reference to the taxable income, and (2) the tax base i.e. the computation of the taxable income.

It should be remembered that the above mentioned two aspects-- tax rate and tax base -- of a country's tax system are complementary. But, the second aspect is very important, as it really determines the effective burden of the tax rates. This point need be emphasised, since in the minds of the foreign investors, a great deal of misunderstanding or confusion may arise about the impact of tax, if their investment policies are superficially related to the tax rates rather than the basis of computation of taxable income. Ignoring this important aspect of assessment of the impact of taxation may lead to misleading calculations and the consequent wrong decisions about investment policy.

As regards the tax liability of the foreign companies, it may be pointed out that an Indian company has to pay income tax in India on its income, whether the income is

earned in India or outside. On the other hand, a foreign company, not resident in India, will pay income tax only on the income accruing or arising to it in India or which is received in India, or by virtue of operations carried on in India and "deemed to accrue or arise" in India. In other words, a foreign company has to pay Indian income tax only on its Indian income, while an Indian company has to pay the tax on its world income. It is with reference to this difference in the extent of income tax liability between a resident company and a non-resident company, the incidence of tax on a foreign company should be calculated.

In the preceding paragraph, the use of the phrase "income deemed to accrue or arise in India" needs some explanation. There are a number of provisions in the Income tax Act under which an income which actually accrues or arises outside India is still deemed to accrue or arise in India. These provisions are given in the sections 4(1), 4(2), 16(1)(c), 16(3) and 42(1). For the purpose of understanding the phrase "deemed to accrue or arise in India", section 42(1) is very important. Under section 42(1), all income, profits and gains accruing or arising to any company (or a person) are deemed to accrue or arise in India, if it accrues or arises to the company (or the person), directly or indirectly,



- (a) through or from any business connection in India. or
- (b) through or from any property in India or
- (c) through or from any asset or source of income in India.
- or (d) through or from any money, lent at interest and brought into India, in cash or in kind or
- (e) through or from the sale, exchange or transfer of a capital asset in India.

These provisions apply equally to "resident" and "non-resident" companies, but it is of particular significance to "non-resident" companies. The provisions are of no concern where income actually accrues or arises in India. Since the resident companies are chargeable on their total world income, it is immaterial in their cases whether the income accrues or arises or whether it is deemed to accrue or arise. Therefore, it is only the non-resident foreign company which has to take special note of these provisions on the application of which its tax liability considerably depends.

The tax liability of the foreign companies also depends on the "double taxation agreements or treaties" signed by a country, say India, with other countries. Under section 49-A of the Indian Income tax Act of 1922, India may enter into an agreement with any other country either for the grant of relief from tax in respect of income on which Indian income-tax has been paid (including super tax) and income

tax in that country or for the avoidance of Double Taxation of income under the Indian Income tax Act or under the corresponding laws in other countries. The Government of India entered into agreements and set out separate rules for granting of double taxation relief on income which was doubly taxed in India and in the U.K., Aden, Ceylon and Part B states of India. The double taxation agreement in respect of Part B States automatically died a natural death with the integration of these States in the territory of Indian Union. The agreement with the U.K. lapsed in 1949 and has not yet been renewed. In 1956, India signed double taxation agreements with Kenya, Tanganyika, Uganda, Zanzibar, Ghana, Nigeria, Sierra Leone, Gambia and Mauritius. An agreement was also entered into between India and Pakistan in 1947. It should be noted that the basis of the agreement between India and Pakistan is not "relief" against double taxation but "avoidance" of double taxation.

Even in the absence of the double taxation agreement between India and any foreign country, there does exist a provision in the Indian Income tax Act by which relief from double taxation is always available to every company or a person who is resident in the taxable territories in any year in respect of incomes accruing or arising outside

the taxable territories, provided it is proved that in respect of that income, income tax is paid in a country outside India.

So far as the U.K. is concerned, the Government of India has reserved powers that the tax relief available under the Indian Income tax Act, may also be given in relation to incomes accruing or arising in the U.K. and chargeable under the Indian Income tax Act. But, these powers have not been exercised so far.

Ofcourse, the lack of agreements with the U.K. does not imply that there prevails widespread double taxation of Income of the U.K. investors in India. The U.K. and the U.S.A., which are the two most important capital exporting countries, have provided unilateral relief against double taxation. Both these countries have adopted the tax credit method of relief. Under this method, the country of residence retains paramount taxing power over the income of the residents but a tax credit is given for taxes paid in other countries. The tax payer has to pay the higher of the two tax rates prevailing in the country of residence and the other country and gets relief in respect of the lower of the two taxes. In 1957, the U.K. adopted another method which is further helpful in easing the problem of double taxation. According to this provision, trading companies managed in the U.K. but

doing business abroad are exempted from income tax and profits tax on their overseas trading profits.

Despite the above mentioned provisions made unilaterally or bilaterally by some countries, double taxation still arises in a number of cases. Under section 42 of the Income tax Act, India taxes income "deemed to accrue or arise" in India. The foreign countries may consider that what India is taxing is really extra-territorial income. In such cases, double taxation of income may take place. Further, under the tax credit system, the difference in definition of taxable income in different countries can also give rise to double taxation because, in such cases, the tax credit may not be fully available. For instance, the U.S.A. gives tax credit only when it considers that taxes paid abroad are properly assessable. Suppose India gives less allowances towards deductible expenses than the U.S.A., income according to the U.S. conception would be obviously lower than what it would be in India. This may result in an inadequate relief of tax given by the U.S.A. In India, the tax relief is limited to the amount of tax which is payable on the doubly taxed income at the lower of the two rates, namely, in India and in the other foreign country. This may also result in double taxation of that income which may not get full amount of relief.

Due to the above mentioned anomalies, it has been realised that tax agreements should be flexible and subject to revision from time to time. Ofcourse, most of the under-developed countries have not played a significant role in international tax agreements. As far as India is concerned, one of the basic reasons which explains the lack of an agreement between India and some capital exporting countries is the conflict over the question whether income should be taxed at source or at residence. While the concensus of opinion is that the principle of taxation at source should be accepted for this purpose, the creditor countries tend to favour the principle of taxation at residence, and the debtor countries tend to favour the principle of taxation at source.

If India, while signing the double taxation agreements with the capital exporting countries, agrees to permit taxation at residence, she may lose considerably in tax revenue. There will be more investments from the capital exporting countries into India than Indian investments in those countries. Hence, more dividends will go out of India to those countries and less dividends will flow to India from those countries. If India and a capital exporting country were to sign a double taxation agreement providing for reciprocal exemption of dividends in the source country,

India will be a net loser in revenue, and the capital exporting country concerned will be a gainer.

Recently, India has entered into double taxation agreements with Switzerland, Sweden, West Germany, France etc. India's first double taxation convention with a developed capital exporting country was signed with Sweden in 1958. The principles governing this convention are:

- (1) that double taxation should be avoided by conferring exclusive taxing rights on one country or the other, and
- (2) that the exclusive rights belong to the country in which the source of income is deemed to be.

Thus, the country of residence abandons its taxing rights over all income arising from sources in the other country, including dividends, interest, royalties, capital gains and pensions. Further, the source country gives no reliefs or abatements from its normal level of taxation in relation to the major classes of business income.

"For the determination of the source of industrial and commercial profits, the Indo-Swedish agreement adopts the "permanent establishment" concept, which is an immense improvement on India's "business connection" principle from the points of view of both equity and certainty"<sup>(1)</sup>

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(1) Taxation in India (II), by E.B. Nortcliffe, in British Tax Review, November-December, 1960, page 422.

An agreement signed by India with West Germany in 1959 fully protects India's taxing rights over income from sources in India. West Germany undertakes to exempt most classes of income from sources in India, including dividends received by a German company from a holding of more than 25 percent of the voting shares of an Indian company. India gives relief only by way of tax credit for German taxes on income from sources in Germany.

The United States agreement with India follows a similar pattern to those of Sweden and Germany. The U.S. has gone to the extent of giving tax credits not only for Indian taxes actually suffered but also in certain cases for the Indian tax which would have been payable, if certain incentive measures had not been applicable, e.g. development rebate and section 15-C relief.

India signed an agreement with Japan early in 1960. Each country retains the major part of its taxing rights in relation to income from sources within its territory. In this respect, the agreement is similar to that with West Germany. The agreement also retains full taxing rights in the country of residence, each country providing for relief by tax credit for taxes payable in the other country on income arising from sources therein.

The above mentioned tax agreements are a clear guide to India's aims in this field. India has replaced the concept of "business connection" by "permanent establishment" concept. Thus, India's emerging pattern differs considerably from the pattern to which the Western countries have been accustomed in the past fifteen years or so.

Having explained the factors affecting the tax liability of foreign companies, it would be worthwhile discussing briefly the past and the present tax incidence on these companies. Historically speaking, it was in 1948 that for the purposes of rebate on distributed profits, a distinction was made between the Indian companies and foreign companies. An Indian company was given a rebate of income tax at the rate of one anna in the rupee on so much of its profits as were available for distribution but were actually not distributed as dividends.

While discussing the tax rates applicable to foreign companies, two things are worth remembering. Firstly, like an Indian company, a foreign company was liable to income tax, surcharge, super tax, penalty tax rates under section 23-A, capital gains tax, wealth tax and excess dividends tax. The last two taxes are abolished since 1959. So, now a foreign company has to pay the first five taxes. Of these five taxes, the penalty tax under section 23-A becomes applicable only



to subsidiaries. In practice, the branches do not come under section 23-A, as ~~is~~ already explained in chapter VIII. Secondly, all the tax deductions and concessions described in chapter VII are equally applicable to foreign companies. Since the foreign companies were and are subject to the same tax rates as applicable to Indian companies, it would be an unnecessary repetition, if a chronological account of the tax rates is attempted here. Such an account has already been given in chapter VI. Therefore, instead of discussing the tax rates structure since its beginning, it would be more useful to attempt here a study of the tax incidence on foreign companies under the old scheme and the new scheme of company taxation.

Under the old scheme of company taxation, in 1956-57, a company, Indian or foreign, had to pay income tax at the rate of 4 annas in the rupee (i.e. 25 percent). From 1957-58 to 1959-60, when the old scheme came to an end, companies had to pay income tax at the rate of 30 percent. A surcharge was added at 1/20th of the income tax, bringing the total to 31.5 percent. Dividends paid to shareholders (whether individuals or companies) who were liable to Indian income tax, entitled the dividend receivers to a credit of the corresponding income tax paid by the company in their

assessments. Income tax on the undistributed profits was not creditable or refundable to the company or its shareholders.

As regards the super tax, it may be pointed out that there was a basic rate of 50 percent. But, various rebates depending upon the nature of income and the nature of the company were allowed. The provisions relating to the various rebates in super tax rates could reduce the basic rate of from 10 percent to 30 percent on different types of companies. Also, there were penalty rates of from 10 percent to 30 percent for the excessive distribution of dividends. In 1958-59, the rates of super tax in force were as follows:-

- (1) 10 percent for a company's income which consisted of gross dividends from a subsidiary Indian company.
- (2) 15 percent for a company's income, other than dividends from a subsidiary. This rate was for those companies whose total income did not exceed Rs.25,000 and which had made the prescribed arrangements for the declaration and payment of dividends in India.
- (3) 20 percent for a company's income, other than dividends from a subsidiary. The other conditions for the applicability of this rate were: the company's total income should exceed Rs.25,000, and the company should have made the prescribed

arrangements for the declaration and payment of dividends in India.

(4) 30 percent for a company's income, other than dividends from a subsidiary. This rate was applicable to a foreign company which did not declare and pay dividends in India.

In regard to the size of the rebate, it should be remembered that the rebate given to the foreign companies could not be reduced or withdrawn under any circumstances. Whereas, in the case of Indian companies, the rebates could be reduced, depending on the amount of bonus shares or the amount of dividends distributed by it in excess of 6 percent of paid-up capital in a particular year.

At this stage of discussion, one can raise one crucial doubt as to why the effective rate of super tax for a foreign company is usually fixed at a higher figure than in the case of an Indian company. The argument for charging a foreign company at a higher rate is that unlike income tax, no amount of super tax payable by a company was and is treated as having been paid by it on behalf of its shareholders. That means the shareholders will have to pay super tax at their own personal rates on the dividends received by them. But, a foreign company distributes its dividends outside India. Hence, even though the dividends are paid out of profits earned in India, the dividends are not considered as income taxable

in India, since the shareholders are not resident in India. This type of tax exemption is not available for the shareholders in an Indian company, and also for the non-resident shareholders of an Indian subsidiary of a foreign parent company. This is the main reason why the effective rate of super tax for a foreign company is fixed at a higher figure than in the case of Indian companies.

An equally important issue is about the 10 percent advantage in the super tax rate in favour of an Indian subsidiary of a foreign parent company over the Indian branch of a foreign company. Though the 10 percent advantage was given in favour of the subsidiaries, in actual practice, this advantage was very largely off-set by two factors. First, the Indian subsidiary had to pay the bonus shares tax or the excess dividends tax, the average incidence of which, according to an estimate (vide A.K.Roy's article on "Position of Foreign Enterprise in the Indian Tax Structure", in Annual Number of Capital, 1957, page 11), stood between 2.5 and 3 percent. Second, since the branch does not pay any dividend, it does not have to pay tax on inter-corporate dividends on behalf of the recipient parent company; whereas, a subsidiary company has to pay this additional tax on the parent company.

Then comes the question of the penalty rates under the excess dividends taxation. In 1958-59, these rates were as follows:-

- (1) 10 percent rate for the dividend range of 6 to 10 percent of the paid-up capital.
- (2) 20 percent rate for the dividend range of 10 to 18 percent of the paid-up capital.
- (3) 30 percent rate for the dividends exceeding 18 percent of the paid-up capital; and, on the face value of bonus shares issued.

One important factor in connection with the super tax rates is that of inter-corporate dividends. It has been already pointed out that no credit on behalf of the dividend recipient is permitted in respect of super tax paid by the company declaring the dividend. Also, super tax is calculated on the basis of gross dividend income and not the net cash dividends. Therefore, the dividend receiving company which gets the income tax credit has to pay only super tax at the appropriate inter-corporate dividend rate on the gross dividend. According to the tax rates of 1958-59, the gross dividend was 1.46 (or  $\frac{200}{137}$ ) times the net cash dividend. On the basis of this data, the super tax rates on inter-corporate dividends in 1958-59 were:-

	Formal Rates of super tax	Effective rate on net cash dividends
Parent company	10%	14.6%
Indian company owning minority shares	20%	29.2%
Foreign company owning minority shares	30%	43.8%

Having known the rates of income tax, surcharge, super tax, excess dividends tax and inter-corporate dividends tax applicable to the foreign companies, it would be now possible to calculate the actual incidence of tax on these companies. It has been already pointed out in the earlier part of this chapter that a foreign company may be a branch or a subsidiary or a minority shareholding company. An Indian minority shareholding company is one which is owned by more than two other Indian companies none of which owns 50 percent, so that no parent subsidiary relationship exists. The owning companies are in turn owned by individual shareholders. A foreign minority shareholding company is one (an Indian company) which is owned by more than two foreign companies, none of which owns 50 percent, so that no parent subsidiary relationship exists.

The following table shows the comparative tax incidence on a branch, a subsidiary and a minority shareholding company, under the old scheme of company taxation.

(Rates as percentage of assessable income)

Amounts of assessable income wholly used to pay dividends  
in range of:

0-6%      6-10%      10-18%      over 18%

Branch      61.5      61.5      61.5      61.5

Subsidiary      56.6      62.4      65.5      68.1

Minority  
shareholding      72.7      75.2      77.3      79.0

Based on Sources: (1) Income Tax Manual, part I, 1957, C.B.R. pages  
LXIV to CXLVII

(2) Budget for 1958-59

(3) Taxation and Foreign Investment, 1958, by N.C.A.E.R.,  
pages 63 to 75.

In the above table, the combined company taxes, namely, income tax, surcharge, super tax, excess dividend tax and inter-corporate dividends tax are given. As for the explanation of the calculations made to measure the tax incidence on foreign companies, the following account is given:-

<u>FOREIGN BRANCH</u>		Rs.
Assessable income		100.00
Income tax @ 30%	30.00	
Surcharge @ 1.51%	1.51	
Super tax @ 30%	30.00	
	-----	
	61.5	61.5
		-----
Assessable income remaining		38.5

Since a branch does not pay dividends but simply transfers the net income, it has not to pay any excess dividends tax. So, the rate of 61.5 remains unaffected.

<u>A SUBSIDIARY:-</u>		Rs.
Assessable income		100.00
Income tax @ 30%	30.00	
Surcharge @ 1.5%	1.5	
Super tax @ 20%	20.00	
	-----	
	51.5	

To this basic rate one has to add the appropriate rates of excess dividends tax and inter-corporate dividends tax. The



same method of calculations will apply to a minority shareholding company. Ofcourse, the table reveals that the earnings by a company from minority shares in an Indian company are taxed rather heavily. The taxation of a foreign minority shareholding company ranges between 72.7 percent to 79.0 percent on the last unit of income.

Some critics have drawn the attention of the Government in regard to the heavy tax on minority shareholding. They have pointed out that this type of tax treatment may prove to be a serious deterrent to foreign investment in India.

It has been also pointed out that instead of fixing differential rates for inter-corporate dividends taxation, it would be better if one uniform rate, say of 10 percent, is fixed for all cases of inter-corporate dividends. This will certainly simplify the corporate tax structure of the country.

Ofcourse, it should be noted that the rates of tax mentioned in the table are applicable to companies which do not get the benefit of development rebate, section 15-C and section 56-A. In the case of new industries most of these benefits will be available at least for the first five years or so. Hence, they will not be asked to pay the

tax rates mentioned in the table. This much about the tax incidence on foreign companies under the old scheme of company taxation which ceased to exist in 1959-60.

In 1959-60, some sweeping changes were introduced in the field of company taxation. These changes have been already discussed in chapter VI and hence need not be elaborated here. In 1959-60, the excess dividends tax was abolished. In 1960-61, the Finance Minister made some proposals in connection with the tax liability of foreign companies. Before these proposals were made, as already pointed out, there was a concessional rate of super tax on dividends received by a parent company from its subsidiary, while inter-corporate investment on a minority basis was taxed at a higher rate. This situation helped the formation of subsidiaries. But, it was later on realised that because of the more favourable treatment given to income derived from the subsidiaries, foreign investors in Indian companies were obviously tempted to ask for a majority holding. The tax on a minority shareholding by a foreign company was substantially higher than on an Indian company with a minority investment. Further, it was realised that in view of the fact that in India, foreign capital is very important, it would not be in the interest of India to levy a higher tax on inter-corporate investment from outside than on similar Indian investment. Therefore,

in 1960-61, the rate of super tax on dividends paid on inter-corporate investment, whether Indian or foreign, and whether on a majority or a minority basis, was fixed at 20 percent. In order that this change may not affect investments already made under different assumptions, the new rate of tax was applied to investment in companies formed after 1st April, 1961.

The other important change under the new scheme of company taxation was in relation to the taxation of royalties received from Indian enterprises by foreign companies. Under the old scheme, the rate of tax, inclusive of income tax and super tax stood at 63 percent which was higher than the rate in any other country. The incidence of this high rate of tax was borne in the last analysis by Indian industry, since the foreign investors naturally asked for a rate of royalty which would give an adequate return to it after deduction of taxes. With a view to enabling Indian industry to secure technical and financial collaboration from the foreign countries on more favourable terms, the Finance Minister reduced the tax on royalties payable on agreements approved by the Government after 31st March, '61 to 50 percent.

The incidence of tax on foreign companies under the new scheme of company taxation can be worked out as follows:-

(Rates according to the Finance Bill, 1961)

FOREIGN BRANCH:-

Assessable income		Rs. 100.00
Income tax @ 20%	20.00	
Super tax @ 43%	43.00	
	-----	
	63.00	63.00
Assessable income remaining		----- 37.00

A SUBSIDIARY:-

		Rs.
Assessable income		100.00
Income tax @ 20%	20.00	
Super tax @ 25%	25.00	
	-----	
	45.00	45.00
Assessable income remaining.		----- 55.00

Thus, when a foreign company floats a subsidiary Indian company after 1.4.1961, the Indian subsidiary would be regarded as a resident company and hence subject to 20 percent income tax and 25 percent super tax, assuming that the total income of the subsidiary exceeds Rs.25,000. After paying a total of 45 percent of tax, the balance of 55 will be received by the foreign company as dividend income. This dividend will attract income tax at 20 percent and super tax at 20 percent (and not 10 percent as in 1960-61) in the hands of a foreign parent company. Therefore, the total incidence of tax on a foreign company floating a

subsidiary in India would be 45 percent plus 40 percent of 55 i.e. totally 67 percent.

However, if a subsidiary Indian company of a foreign company does not distribute any dividend but capitalises its entire profits and issues bonus shares, it will be liable to further super tax at  $12\frac{1}{2}$  percent of the profits as reduced by income tax and super tax payable thereon in which case the total incidence will be 45 percent plus  $12\frac{1}{2}$  of 55 i.e. nearly 52 percent.

But, if the subsidiary of a foreign company comes under section 56-A, the subsidiary would be exempt from the super tax on its dividend income. Consequently, the total tax incidence will be 45 percent plus 20 percent of 55 i.e. 56 percent.

MINORITY SHAREHOLDING COMPANY:-

		Rs.
Assessable income		100.00
Income tax @ 20%	20.00	
Super tax @ 25%	25.00	
	-----	
	45.00	45.00
		-----
Assessable income remaining		55.00

Thus, when a foreign company holds only minority shares in an Indian company formed and registered on or after 1.4.1961, on which the investment yield is, say, Rs.100 earned through

the Indian company, the Indian company will first pay income tax and super tax on its own income at 45 percent; and a foreign company getting 55 percent of the balance will again pay income tax at 20 percent and super tax at 20 percent on the balance available. The total tax incidence on the foreign investment would be 67 percent.

However, if the company comes under section 56-A, the total tax incidence will be 45 percent plus 20 percent of 55 i.e. 56 percent only.

From the above calculations of tax incidence on a foreign branch, a subsidiary and a minority shareholding, it can be said that under the new scheme of company taxation, the tax incidence on a branch has increased from 61.5 percent to 63 percent. On a subsidiary, it has remained almost the same. On the minority shareholding company, it has decreased from 79.0 to 67.0. But, on the whole, the new scheme of company taxation cannot be said to have adversely affected the foreign investment in India.

Some persons compare the Indian tax rates with those prevailing in some capital exporting countries such as the U.K. and the U.S.A. and jump to a conclusion that Indian tax rates on foreign investors are higher. They forget that International comparisons of tax incidence are bristled with technical difficulties, since tax rates are meaningful only

in relation to the definition of taxable income and also the deductions and concessions.

In India, three major factors operate in influencing the profitability of a new company, either Indian or foreign, in relation to the corresponding advantages in other countries of the world. These three factors are: development rebate, the tax holiday under section 15-C and the tax benefit under section 56-A. These factors are decisive in determining whether or not at least in the initial period of a company's life, an advantage is obtained in locating it in India.

Though ofcourse, it may apparently appear that the Indian rates of company taxation do not compare favourably with those of some capital exporting countries, say the U.K. and the U.S.A., it should not be ignored that the cumulative effect of development rebate, section 15-C and section 56-A certainly tend to reduce the differentials in corporate earnings. Therefore, on the whole, India's existing company tax system does not prove to be a deterrent to foreign investments.

But, if India needs more and more foreign capital for her economic development, she will have to keep in view the tax systems of the capital exporting countries and adjust her tax provisions accordingly. It is, ofcourse, true that the flow of foreign investment is influenced by other economic and political factors too. But, the tax system of a country has a definite impact on the major decisions about investments abroad.

Therefore, in future, India will have to see that her tax incidence should not only be relatively equal to that prevailing in the countries which are India's competitors in the International capital market (such as Burma, Ceylon, Indonesia, Pakistan etc.), but also her tax system should offer some special incentives for foreign investors. Further, the tax deductions and concessions made available to the companies are adequate mostly for the short term investments in India. If India needs more and more of the long term foreign investments, she will have to give a serious thought to the problem of tax incentives necessary to attract the long term foreign capital in the country.