INDIA AND EMERGING GLOBAL TAX LAWS

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I Introduction

CORPORATE TAXATION is an important consideration in business investment and a significant source of income for the government. There are no objective criteria for deciding on an appropriate rate of taxation. In India, revenue had been the major consideration with the government. This did not come greatly in the way of investment since the economy until 1991 was largely insulated. With opening of the economy and drive towards globalisation it has become necessary to reassure whether Indian rates of taxation are such that the companies are not placed in a disadvantageous position in global competition. In other words, the rate of corporation taxation has to be in tune with the rates prevailing in other countries.

Tax payable by the company is an important segment of the gross profits. The rates of taxation in the last five years have been as under :

Financial year	*Corporate tax + surcharge*
1989-90	50 + 5
1990-91	50 + 8
1991-92	40 + 15
1992-93	45 + 15
1993-94	45 + 15

The high rate of corporate taxation was justified on revenue considerations. In fact the small reduction which was announced in the last Budget was postponed by the Finance Minister by a year because of its impact on the fiscal deficit. The importance of such taxation can be judged by its contribution to total tax revenue of the central government.

	1994-95 (Rs. crore)
Corporate tax revenue	12480
Total tax revenue	87136

Corporate taxation contributed about 14.3 per cent to the total tax revenue. In many countries the percentage would be higher, not because the tax rates are high but because revenue from other sources is relatively lower. Most countries have been able to achieve the balance between needs of the government and taxability of the corporate sector. The object of this paper is to judge whether tax system in India conforms to this criteria.

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II Corporate income tax rates

A worldwide trend in corporate taxation is discernible, especially among developing countries. Tax rates are falling while incentives and special deductions are being offered to companies. Appreciating this trend of falling rate, the Chelliah Committee recommended that the corporate tax rates inclusive of surcharge be reduced to 40 per cent. At present the domestic companies are subject to tax at 46 per cent inclusive of surcharge. A foreign company is subject to tax at a rate as high as 55 per cent.

As shown in Table I, India's competitiveness is seriously weakened by its tax rates which exceed those in almost all the countries.

TABLE I

Corporate tax rates in selected countries

Country	*Rate*
Argentina	20-36
Australia	30
Austria	34
Belgium	39
Brazil	30
Canada	28
Columbia	30
Chile	15
Denmark	38
Ecuador	25
Egypt	32-40.55
Finland	27
France	34
Germany	30-45
Hong Kong	17.5
India	46
Indonesia	15-34
Ireland	40
Israel	39
Italy	36
Japan	28-37.5
Kenya	37.5
Korea (DPRK)	20-34
Luxembourg	33
Malaysia	32
Mexico	34
Morocco	38
Nambia	38
Nepal	40
Netherlands	35-40

New Zeland	33
Nigeria	40
Norway	28
Pakistan	30-50
Panama	30-34
Peru	30
Philippines	35
Portugal	36
Qatar	35
Singapore	27
South Africa	40
Spain	35
Sri Lanka	35
Sweden	28
Taiwan	15-25
Thailand	30
Turkey	46
Uganda	30
UK	25-33
USA	35
Venezuela	20-30
Zambia	35

High rate of taxes tend to reduce generation of internal resources and in turn restrict economic expansion and growth. Direct and indirect taxes are also an important factor in influencing prices of products and distributable profits to shareholders. That apart, India faces stiff competition in attracting foreign investment. In the neighbouring countries with whom India will have to compete for attracting foreign investment, the rates are much lower, indeed lower than those suggested by the Chelliah Committee. For example, in Indonesia the rate of tax ranges from 15 to 34 per cent, in Taiwan, it is 15 to 25 per cent, in Pakistan 30 to 50 per cent, Sri Lanka 35 per cent and in Nepal 40 per cent. An important challenge therefore, faces India to find an optimum rate(s) of corporate income tax, bearing in mind the falling trend of tax rates all over the world.

III Tax rates under tax treaties

India has concluded comprehensive tax treaties with 40 countries. Special rates of with-holding tax have been provided for in these treaties. In addition, there are provisions in the Income-tax Act for providing unilateral tax relief in respect of income that is taxed both in India and in a foreign country with which it has no double tax avoidance treaty.

The government's desire to invite foreign investment would be better served if tax rates on dividend, royalty and technical services fees and interest payments to foreign companies are brought to international levels. The high rate of withholding tax from dividends, makes investment in India unattractive *vis-a-vis*

investment opportunities available in other competing countries. Similarly, interest paid on funds borrowed from the international market also carries a high rate of with-holding tax. The general corporate tax of 30 per cent is payable on royalty and technical services fees and 20 per cent on dividends and interests paid to foreign enterprises. Though some of the tax treaties between India and other countries marginally bring down the rate of tax applicable, it is necessary that the general rate itself should be brought down to 10 per cent or less, since the tax cost is ultimately borne by the Indian counterparts only.

Royalties and technical service fees are taxed at the rate of 30 per cent. Although this rate is reduced in case of countries with whom India has a tax treaty, yet such foreign companies of countries with which India has no tax treaties are subject to tax at a very high rate of 30 per cent. In order to attract transfer of sophisticated technologies into India, there is, therefore, a very strong case for reducing the rate of income tax payable in India by such foreign companies on royalties and fees for technical services received by them from an Indian concern.

A number of tax treaties have also become old. Many changes have also taken place in the tax laws of India as well as other countries with whom it has entered into such treaties. To meet with the changing scenario, a number of tax treaties with certain countries have already been revised. These countries include, Japan, Norway, Sweden, Poland, Denmark, UK and Italy. The new agreements provide for reduced tax rates in specified areas which should help in modernisation and growth in Indian industry by encouraging flow of investment and technology in essential areas. With a view to having fresh tax treaties, negotiations with some other countries are underway. These countries include, Belarus, Israel, Kuwait, Malta, Mexico Nigeria, Oman, Turkey, Ukraine and Vietnam. The tax rates in the new as well as revised tax treaties need to be brought down to at least 10 per cent. Such a move, it is hoped will certainly meet with the objective of attracting capital as well as technology in India.

Worldwide in tax treaties, dividends on an average are taxed at the rate of 10 per cent, but for most of the treaties signed by India the rates have been negotiated at 15-20 per cent. Similarly, worldwide the trend for tax on royalty income is 15 per cent, but the average for treaties signed by India is between 20-30 per cent. This needs to be lowered.

Although there is a realisation on reducing the rate of taxes on foreign companies, there seems to be none over cutting down on time taken on negotiations. From the date they begin to the date the actual agreement is notified it takes about three to four years. Even after they are complete it takes over a year to sign the agreement and notify it. Such delays need to be avoided.

IV Discriminatory tax treatment in case of domestic companies and foreign institutional investors: need for level playing field

Table II shows the incidence of tax on certain income in the case of foreign institutional investors and domestic companies:

TABLE II

	Foreign institutional investors (FIIs) / Domestic companies		
		Venture capital	*Others*
Long term capital gains on sale of securities	10%	23%	34.5%
Short-term capital gains on sale of securities	30%	46%	46%
Investment income	20%	46%	46%

It is true that domestic companies enjoy the advantage of indexation. But this does not put them on par with foreign investors except in very unusual circumstances. *First*, the benefit of indexation is only partial. *Second*, the benefit becomes adequate to compare with the lower tax paid by foreign investors only when the rate of inflation is unusually high. Broadly domestic companies will be on par with foreign companies when the inflation rate over a long period of time is well over 7 per cent annually. Most often inflation has been under 6 per cent over long periods though there have been unusual years when it has exceeded 10 per cent. By and large the capital gains tax payable by domestic companies will be higher.

There is need to promote investment in foreign currency by overseas financial institutions. It is equally important that domestic companies are encouraged to invest their funds in shares and securities and accorded equal tax treatment. In other words, there should be a level playing field for all investors irrespective of whether they are Indians or foreigners. For this purpose, it is desirable to reduce the rates of tax applicable to Indian investors to bring them in line with the concessional rates of tax applicable to foreign investors.

V Dividend taxation

Under the existing classical system in India, inter-corporate dividends are exempt from tax to the extent that dividend income received by a company is distributed by it. When dividends are distributed to shareholders, this income together with that from UTI, interest on bank deposits, *etc.*, qualify for deduction upto a maximum limit of Rs. 10,000.

Double taxation of corporate profits is generally avoided in several countries by imputation system whereunder tax paid by a company is given credit against tax liability of the shareholder. In some countries the dividends paid out of taxed profits of the companies are fully exempt in the hands of shareholders. Recently, in Sweden double taxation of corporate profits has been abolished by exempting dividends in the hands of shareholders. Table III shows the alternative tax treatments accorded to dividend income by select countries:

TABLE III

Dividend taxation : grossing up/imputation of tax

Denmark	: Individuals receive a 25% tax credit on dividends net of with-holding tax, but they must declare as taxable income the gross dividends plus the credit.
Finland	: Individuals are given credit in full in personal taxation for income tax paid by the dividend paying companies.
Germany	: Resident recipient of dividends is given the 36% corporation taxes credit.
Italy	: Individual may claim a tax credit equal to 36% tax already paid by the distributing company.
Malaysia	: Dividends paid to individual shareholders by pioneer companies receive the regular income tax credit.
Peru	: Dividends are included in regular taxable income for individual residents with a related credit.
Singapore	: Dividends received are all entitled for tax credit.

Tax deducted at source treated as final tax liability

Belgium	: If the recipient is a resident individual the with-holding tax is in principle a final tax.
Japan	: Resident individuals, are subject to a 35% rate if they choose not to aggregate their dividend income with income from other sources.
Nigeria	: Dividends received by a resident are subject to with-holding tax of 15% which is a final tax.

Exemption

Hong Kong	: Dividends paid by corporate concerns paying taxes are not subject to with-holding and are exempt from further tax once remitted to the recipient.
Mexico	: Dividends are not included in taxable income by the recipient.
Pakistan	: Dividend income from specified types of companies is tax exempt.
The Philippines	: Dividend income is not included as part of taxable income.
South Africa	: Exemption includes building society dividends.
Sweden	: Dividends received by residents on shares in Swedish companies are exempt from tax.

It would be obvious that countries offer a more favourable treatment to dividends in the hands of the shareholder or alternatively taxation of profit in the hands of the company should recognise dividend as a charge on profits of the company.

VI Dividend as a charge on profits of company

In computing the taxable profits of a company, interest paid on borrowed funds is generally allowed as deduction. There are however, other methods of raising funds for the business such as issue of shares either to preference or ordinary shareholders. All these funds raised are treated as (loan or equity) capital of the company and employed in its business. When investing in a company, the shareholders generally look for two things, *viz.*, (*i*) a reasonable return by way of dividends; and (*ii*) appreciation in the value of shares. In doing so, they also bear risks, for one can never be sure of the success of projects conceived and undertaken by the company. Shareholders sometimes have to wait for years before they receive dividends. Their wait may be prolonged as once the company starts to make a profit it has to pay a significant portion of the profits as income-tax. From the company's point of view, investments by shareholders and loans advanced by other creditors do in fact resemble each other in character to a certain extent. Both provide funds to the company for its business. Thus, there is a strong case for, (*i*) treating the dividends distributed by a company, subject to certain limits, as a charge on the profits of a company; and (*ii*) such dividends to be allowed as deduction in computation of the company's taxable income. Such a provision exists in the tax laws of some countries, *e.g.*, Belgium, Egypt, Israel and Norway.

VII Compromise arrangement and reconstruction of companies

In a scheme of amalgamation of companies, no tax is levied on the revenue or capital gains under the Income-tax Act nor on transfers under the Gift Tax Act. The Chelliah Committee has made a very good recommendation in its Final Report for similar exemption to be provided in the case of a compromise arrangement or reconstruction of companies. To remove any doubt concerning taxability of assets or shares received by a shareholder in a scheme of compromise arrangement and reconstruction of companies, the committee has suggested that clarification be issued to the effect that the deeming provision under section 2(22)(*a*) of the Income-tax Act shall not apply in such cases. Under the section, any distribution by a company of accumulated profits, whether capitalised or not, if it entails release by the company to its shareholders of all or any part of the assets of the company, will be deemed as a dividend and included in the total income of the shareholder.

The committee has also recommended that in order to ensure that the transferee does not avoid tax on any capital gains when he himself transfers an asset acquired under the scheme, suitable amendments should be made in the Income-tax Act.

Companies at times grow beyond their manageable size and require reconstruction. Sometimes differences may also arise amongst the investors/major shareholders which call for division of business assets. Demergers have assumed added significance in the new era of international competitiveness where Indian companies will have to essentially restructure and reposition themselves to be more competitive and efficient. The aforesaid recommendation, therefore, needs to be implemented by government. To prevent abuse of the scheme, it may be

provided that the transferee of shares or any other assets shall not be allowed further to transfer the shares/assets for a minimum of three years. UK tax laws also provide for tax exemption in case of demergers of companies. In fact, the International Fiscal Association has also planned to discuss this issue in its forthcoming annual Congress to be held in August at Toronto.

VIII System of advance ruling for non-residents

A scheme for giving advance rulings in respect of transactions involving non-residents was introduced by the Finance Act 1993. Under the scheme, advance rulings can be given on questions of law or fact both in relation to a proposed transaction as well as one undertaken by a non-resident. Any non-resident desirous of obtaining an advance ruling can make an application before the authority in the form and manner prescribed under the rules alongwith the payment of a fee of Rs. 2500.

A request for a ruling can be withdrawn within thirty days. After receipt of the application, the authority will send a copy of the application to the concerned commissioner and if necessary can call for the relevant records. It has been given the discretion either to allow or reject an application. However, it cannot issue the ruling where the question raised in the application, (*a*) is already pending in his case before any income-tax authority, the appellate tribunal or any court; (*b*) involves determination of fair market value of any property; (*c*) relates to a transaction which is designed *prima facie* for the avoidance of income-tax.

The authority is required to issue the ruling within six months from the date of receipt of the application. As this is an authority constituted to provide immediate clarifications on urgent issues relating to business decisions, the time limit should not be more than two months.

The advance ruling, it is provided will be binding on the applicant who has sought it and in respect of the specific transaction in relation to which it was sought. The commissioner will also be bound by the ruling. This scheme does not provide for right of appeal to the courts from the advance rulings. It may be noted that under the Swedish procedure of advance rulings, tax-payers and the government have the right to appeal to administrative courts from such rulings. Further, under this system, the Board's advance rulings are not binding on the tax-payer and therefore, as far as he is concerned, they are advisory in nature. As regards government, the rulings are binding to the extent the tax-payer requests. It is suggested that advance ruling should be made appealable by the assessees.

For the time being, resident tax payers have not been provided with the facility of advance ruling. In the context of Indian tax-payers, the relevance of advance rulings cannot be overstated. In view of the complexity of Indian tax laws, there has been prolonged litigation and different High Courts give different rulings on the same question of law. Consequently an uncertain situation continues for quite a long period till the Supreme Court finally decides the issue. Retrospective legislative amendments in fiscal laws further create problems for the tax-payers particularly where the Supreme court has decided in favour of them. In view of the uncertainties haunting the helpless tax-payers, advance

rulings would certainly provide relief and facilitate them in making the final decision. Therefore, as already indicated by the Finance Minister this facility of advance rulings should be extended to resident tax-payers also at the earliest.

IX Need for allowing full deduction of expenses incurred for raising Euro-Issues

In the context of the high rate of interest and inadequate availability of finance from domestic sources, many Indian companies are presently tapping the capital market abroad. They are encouraged by factors like lower interest rates and availability of finance in bulk in such markets.

The importance of attracting foreign capital for investment in India is evident from the fact that the government is encouraging foreign investors by providing special tax treatment under the newly incorporated section 115*AC* of the Income-tax Act. This section provides for levy of concessional income tax of 10 per cent in respect of investment income in the hands of foreign investors from equity shares and convertible bond issues denominated in foreign currencies raised by Indian companies. Similarly, long term capital gains on the sale of such bonds or shares are also taxed at the rate of 10 per cent.

The Indian companies who are raising funds from abroad are to meet huge expenses in foreign currency in connection with raising of such funds. However, in view of the Supreme Court judgment in the case of *India Cement Ltd.* v. *C.I.T.*,[1] these expenses are not allowed to be deducted as revenue expenditure for the current year even though they are allowed to amortise such expense in ten equal instalments deferred over ten assessment years under the provisions of section 350(2)(*c*) of the Income-tax Act. Such deferment of the expenses ultimately increases the cost of raising such capital.

In view of the need for encouraging Indian companies to raise more funds from the world capital market it is desirable to give special treatment to them by allowing all expenses connected with raising of such funds as revenue expenditure in the current year's income particularly when concessional tax treatment is provided to foreign investors. Alternatively, the period of amortisation under section 35*D*(2)(*c*) may be brought down to three years from the present ten years.

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1. (1966) 60 I.T.R. 52.