# TAXATION AND FOREIGN INVESTMENT

*by*

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After the second world war, the emergence of new nations in the international arena has added to the economic problems of both the developed and the developing countries. These emerging nations were formerly the colonies of the Big Powers and after gaining independence found that they did not have the financial resources to develop their economy. This factor prompted them to seek help from the developed countries. The aid given by the latter was either in the shape of loans at governmental level, or by investment of private capital in these countries. The developing nations are, however vying with each other to attract the foreign private capital, because the demand for it is much more than the limited amount available for investment.

## Factors for Foreign Investment

The principal factors responsible for attracting foreign private capital are : availability of resources; adequate supply of labour and power ; good means of communications and transport; political stability ; well developed monetary system, a good expanding market ; freedom from undue governmental interference ; expectation of a reasonable profit and the level of taxation.[1] Amongst these factors, the foreign investor considers the tax laws of a developing country to be of prime importance. These laws can either help in attracting the capital from developed countries or deter them from investing it even in deserving developing countries. This is why taxation and foreign private investment are so much interrelated, that the developing countries take special care to see that their laws do not act as deterrents to the investment of foreign private capital in their countries. Taxation is also one of the instruments by which government can regulate private enterprise. This is very much true in the Indian tax system. This paper attempts to analyse the efforts made by India, through

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1. Background paper on "Taxation in India and Foreign Private Investment" prepared by the Investment Centre for a Seminar on International Investment held in New Delhi in November, 1969.

its taxation laws, to attract foreign private capital for its economic development and at the same time regulate private enterprise-

The presence of foreign capital in India in pre-independence era could hardly be gainsaid. But, neither its question was commensurate with the needs of the country, nor was it diversified to cover the basic industries. The dawn of Independence brought with it further pressure on the Indian economy, which was in the process of recovering from the dismal effects of the second World War. The large influx of refugees ensuing the partition of the country, the acute food shortage and the increasing population, made it imperative for the Indian government to take necessary measures to improve the situation, if at all the newly acquired freedom had to be consolidated within the democratic framework. The first obvious source to which the government could look for money, materials and technical assistance, was the developed countries. It is gratifying to note that the aid[2] sought for was immediately forthcoming, which has helped India to wade through its problem ridden five year plans during these two decades.

**Policies Regulating Foreign Capital**

The first policy statement regarding the investment and regulation of foreign private capital in India was made by the government in 1948,[3] and reiterated in 1949 by the late Jawaharlal Nehru, Prime Minister of India. The salient points of his statement were :

(*i*) all undertakings, Indian or Foreign, should conform to the general requirements of the Government's Industrial Policy ;

(*ii*) as regards existing interests no restrictions or conditions would be imposed, which were not applicable to similar Indian enterprises ;

(*iii*) facilities for the remittance of profits and withdrawal of foreign capital investments would be allowed subject to exchange restrictions ;

2. The aid asked for was of two kinds ; firstly, loans etc. by the foreign governments and secondly, the investment of foreign private capital in the industrial projects of the country.
3. Statement issued by the Ministry of Industay and Supply, Government of India, on April 6, 1942 :

   The Government of India agrees with the view of the Industries Conference that while it should be recognised that participation of foreign capital and enterprise, particularly as regards industrial technique and knowledge, will be of value to the rapid industrialisation of the country, it is necessary that the conditions under which they may participate in the Indian industry should be carefully regulate in the national intezest....

The Prime Minister also assured that "the government would also so frame their policy as to enable further foreign capital to be invested in India on terms and conditions that are mutually advantageous." The Indian government's policy on foreign private investments has remained unchanged over these years.

In an International seminar on "Taxation in India and Foreign Private Investment," held in Delhi in November, 1968, the Deputy Prime Minister of India, told the participating foreign businessmen, that foreign private investment of Rupees Fifty crores a year was inadequate for India's requirements.[4] He assured the foreign investors that India was doing its best to attract foreign private capital and that they must take advantage of the favourable conditions[5] in the country to increase their investments. The remark of Mr. L.N. Birla[6] was apt :

> India can offer you, such of those who are brave and imaginative enough to look for new horizons, as many opportunities as any other countries, if not more.

This sentiment was re-echoed recently[7] by Mr. A.L. Watson, the President of the International Chamber of Commerce, who told a press conference in India that the climate for foreign investment in the country was quite good.

With the manifestation of desire by the Indian government to welcome foreign private investment, steps have been taken to attract foreign capital. The tax laws of a country, as mentioned earlier, have an important role to play in attracting foreign private capital,[8] and India, keeping

4. India's share is not even two percent of the total flow of private foreign investment from the developed to the developing countries, and it is less than one percent of the total American business investment outside the United States is the biggest investor followed by the United Kingdom.
5. These conditions are the stable democratic system and the bright economic outlook.
6. Mr. L.N. Birla is the Chairman of the Indian Committee of the International Chamber of Commerce, which in collaboration with the Indian Investment Centre, had orgauised the Seminar.
7. February 12, 1969.
8. Mr. K.S. Sundara Rajan, Chairman, Central Board of Direct Taxes, India, had this to say about Indian taxation, in his address to the delegates of International Seminar on Investment, mentioned earlier :

   > The structure of our income-taxation can now be said to be growth-oriented. It contains a large number of provisions for tax exemptions, concessions and reliefs designed to serve the objectives of encouraging personal savings and investment, promote industrial development in general, channelising investment in priovity sectors of industry and economy, facilitating the inflow of foreign investment and stimulating exports. Basically, the Indian tax laws do not discriminate aganist foreign investment.

this in view, has introduced a number of tax incentives to encourage participation of both domestic and foreign capital in its industrial development and at the same time regulate this investment in select areas. However, these incentives by themselves, are not sufficient to achieve the abovementioned object, as they are to be taken in conjunction with the over-all tax policy and other factors; nevertheless they represent a sincere attempt made by the Indian government to attract capital.

### Tax Concessions

Foreign private capital usually takes the form of participation in the equity capital of an industial undertakings registered as a company in India. These undertakings whether domestic or foreign are eligible for the following tax concessions ;

(*a*) *Tax Holiday*[9] : This concession is an important one. Under it, new industrial undertakings established after March 31, 1948, are exempt from income tax upto 6% per annum of the capital employed in the undertaking and is available for five years beginning with the year of commencement of production or operation. Any deficiency of profits during this period from 6% of the capital employed can be carried forward and deducted from profits upto a further period of three years. From April 1, 1961, this concession has become available to new hotels and from the same date in 1962 to cold storage plants and plying of ships.

(*b*) *Dividends from New Industrial Undertakings*[10] : Dividends paid out of "tax holiday" profits by the undertakings (including hotels and ships) are exempt from tax in the hands of corporate as well as individual shareholders.

(*c*) *Special Deducation of 8% of Profits in case of Companies Engaged in Priority Industries*[11] : A deduction of 8% of profits of a priority industy is available to all domestic companies for purpose of computing the taxable income, except those companies having an income of Rs. 50,000 or less. In effect this concession means 8% reduction in tax.[12]

9. Section 80-J of the Indian Income-tax Act, 1961.
10. Sec. 80-K.
11, See. 80-I.
12. Mr. K.S. Sundara Rajan, has remarked as follows in this connection :

 I may mention here that the specified industries for this concession as well as for the development rebate at the higher rate of 35%, cover a very wide field of basic and capital intensive including export-oriented industries, practically all the industries in which the foreign investor is interested.

(*d*) *Concessional Treatment of Inter-Corporate Dividends*[13] : This concession facilitates the taxation of income from inter-corporate dividends at a reduced rate. Thus a foreign company receiving dividends from a closely-held Indian company engaged in any of the specified priority industries, is exempt from tax on 80% of such dividends and on 65% of the dividends received from any other domestic company. This results in the effective incidence of tax on such dividends working out to 14% on the former and 24.5% on the latter. A domestic company which receives dividends from any other company is exempt from tax on 60% of such dividends; in this case the effective incidence of tax on such dividends is 22%.

(*e*) *Concessional Tax on Royalties and Technical Service Fee Received by a Foreign Company*[14]: If a foreign company has made an agreement for receiving royalties from an Indian concern on or after April 1, 1961, or for technical service fees under agreement entered into after February 29, 1964, and the agreements have been approved by the government, then the foreign company will pay tax at a concessional rate of 50% in respect of such income from royalties or technical service fees, as against the rate of 70% applicable to its other income.

(*f*) *Exemption from Surtax in case of Foreign Companies in respect of Income from Royalties, Interest and Technical Service Fees*[15] : A nonresident company receiving interest or technical service fees or royalties from the government or a local authority, or an Indian company, is not charged to surtax on this income.

(*g*) *Depreciation*[16] : Normal depreciation is allowed at prescribed rates on buildings, furniture, plant and mechinery used for the purposes of the business by an undertaking. The depreciation allowance is generally calculated on the "written down value" or the "declining balance" method. For working the plant and machinery on double or triple shift, an additional depreciation allowance at a rate equal to 50% of the normal depreciation in the former case and another allowance of 50% in the latter case, is allowed. The depreciation allowance can be carried forward indefinitely, subject to certain conditions, if it cannot be absorbed in any one year by the profits of the business. To give an

13. Sec. 80-M.
14. *Schedule* 1, Part II, 2 (b) (iii) & (iv), Finance Act, 1968.
15. *First Schedule*, 1 (ix) & (x), The Companies (Profits) Surtax Act, 1964.
16. Sec. 32.

impetus to the construction of hotels, an initial depreciation allowance equal to 25% of the actual cost of erection is permitted, if the hotel is erected after March 31, 1967.

(*h*) *Development Rebate*[17] : This concession is perhaps the most attractive one. A special deduction by way of development rebate is allowed, besides depreciation allowance, against profits of a business, at a specified percentage of the cost of a new ship or a new plant or machinery (excluding office appliances and road transport vehicles) owned and installed by a person and used wholly for the purposes of his business. The rates of deduction vary from 40% to 15% from asset to asset. This incentive is thus really a subsidy from the Government to the assessee on new ships, plant and machinery, as it, together with the depreciation allowance allows an enterprise to deduct upto 135% or 120% or 140% of the actual cost. Development rebate is given only if certain conditions are fulfilled. With effect from April 1, 1964, development rebate is allowed on used machinery or plant imported for the first time.

(*i*) *Reduction of Capital Gains Tax*[18] : Where an individual who is not a citizen of India or a foreign company derives any capital gains from the transfer of shares in an Indian company and re-invests in full or in part, the amount of consideration in an investment approved by the Government, within a period of two years from the date of the transfer, the tax charged on the capital gains on the amount re-invested is refunded.

(j) *Tax-free Interest on Loans*[19] : The interest on moneys borrowed from a foreign source and brought into India in cash or in kind is normally taxable in the hands of the non-resident recipient. However, the interest payable to an undertaking in India on the following is exempt from tax :

(*i*) on moneys which have been borrowed under a loan agreement from approved financial institutions;

(*ii*) if moneys have been borrowed or debt incurred for the purchase of capital plant or machinery or new materials, outside India. The exemption is allowed to the extent of rate of interest approved for this purpose by the government in each case.

17. Secs. 33 and 34.
18. Sec. 54-A.
19. Sec. 10 (15) (iv).

(*k*) *Exemption from Income-tax on Remittance to India*[20]: Remittance to India out of foreign profits or out of capital are completely exempt from Income tax.

(*l*) *Exemption from Tax on Income from Goods Purchased for Exports*[21] : In the case of non-residents, no income shall be deemed to accrue or arise to them in India, through or from operations which are confined to the purchase of goods in India for the purpose of export.

(*m*) *Tax Credit Certificates*[22] : From 1965 the government has started a bold and novel tax incentive in the form of tax credit certificates. Five kinds of certificates were issued to serve different objectives. For our purpose, only two of them are discussed below.

In case of industrial companies which are manufacturing any of the articles enumerated in the *first schedule* to the Industries (Development and Regulation) Act, 1951, and if their liability to corporation tax on manufacturing profits is in excess of the corresponding tax liability for the base year, they are to be granted tax credit certificates for an amount equal to 20% of the excess tax, limited to 10% of the total tax liability for the year.[23] This concession is available for five assessment years from 1966-67, to 1970-71 and the base year is 1965-66, or any later year in which the company becomes liable to tax. The tax credit certificates are tax free. The tax credit has to be utilised within a period of three years for specified purposes.

Any person engaged in any of the specified industries is entitled to tax credit certificates calculated at a rate not exceeding 25 per cent of the amount of the central excise duty, payable on excess of goods cleared by him during any of the financial years from 1965-66 to 1969-70, over the goods cleared during the 'base year'.[24] The 'base year' is 1964-65 or any later financial year in which the concern begins to manufacture goods.

20. Income tax Circular in 1968.
21. Sec. 9 (1) (i) (b).
22. Chapter XXII-B of the Income-tax Act, comprising Sections 280-Y, 280-Z, 280-ZA, 280-ZB, 280-ZC. 280-ZD and 280-ZE.
23. Sec. 280-ZB.
24. Sec. 280-ZD.

(n) *Export Markets Development Allowance*[25]: This tax incentive for export promotion envisages a weighted deduction in the computation of the taxable income of domestic companies as well as resident taxpayers, of $1\frac{1}{3}$ times the export promotion expenditure incurred by them. This includes expenditure on advertisement, market research and the maintenance of a branch outside India.

(o) *Agricultural Development Allowance*[26] : For improving agricultural productivity and increasing supplementary food resources, new tax incentive has been introduced from 1968. It gives a 'weighted deduction' from income, equal to $1\frac{1}{3}$ times the amount of expenditure incurred by companies which use the products of agriculture, animal husbandry, or dairy or poultry farming as raw material for their manufacturing and processing activities, on certain specified items like fertilizers, seeds *etc.* The allowance is admissible in respect of expenditure incurred after February 29, 1968.

(p) *Amortization of the cost of Patent Rights and Copyrights*[27] : This incentive allows any capital expenditure incurred after February 28, 1966, on the acquisition of patent rights or copyrights to be deducted in equal annual instalments over a period of fourteen years as reduced by the number of complete years which have elapsed since the commencement of the rights and before their acquisition by the taxpayer.

(q) *Exemption of the first Rs. 500/- of dividends received from Indian Companies*[28] : Any assessee is entitled to an exemption of Rs. 500/- or less, received as dividends from any Indian Company, in computing his total income. This amount has been raised to Rs. 1,000/- by the Finance Act of 1969, with effect from April 1, 1970.

(r) *Incentive for Rendering of Technical Services and Know-how*[29] : An Indian company rendering technical services or technical know-how to a foreign company is exempt from tax on dividends, royalties and technical services fees received from such foreign company.

25. Sec. 35B.
26. Sec. 32C.
27. Sec. 35A.
28. Sec. 8C-L.
29. Secs. 80-N & 80-0.

(*s*) *Incentives to Foreign Technicians, Consultants and others* : These incentives are as follows ;

(*i*) remuneration of a foreign technician for a period of three years is exempt from tax if the Government has approved the contract of service. The exemption is extended to a further period of five years, if the employer agrees to pay the tax and the Government approves the continued employment of the technician in India.[30]

(*ii*) remuneration of a foreigner from a foreign enterprise for services rendered in India during a period of stay not exceeding 90 days, is exempt, subject to certain conditions.[31]

(*iii*) passage moneys paid to a foreigner employee, his wife or children in connection with home leave outside India is exempt, subject to certain conditions.[32]

(*iv*) direct deduction within a ceiling of Rs. 1,5000/- in the case of one child and Rs. 3000/- in case of more than one child, below the age of 21 is permitted on educational expenses of the children of the foreigners.[33]

(*v*) remuneration of a foreigner taking up research work in India in connection with a scheme approved by the government is exempt for a period of twenty four months provided the remuneration is paid by a foreign government, or an Institution established outside India.[34]

(*t*) *Relief from Double Taxation*[35] : To give relief from International double taxation, the Indian Income-tax Act has provided two methods. One, is the giving of a tax credit against the Indian Income tax for the amount of tax paid in a foreign country on the doubly taxed income. The other, is the conclusion of tax treaties with other countries for the avoidance of double taxation and fiscal evasion.[36] The former is a unilateral method while the latter is a bilateral one. Both of them reduce the

30. Sec. 10 (6) (vii).
31. Sec. 10 (6) (vi).
32. Sec. 10 (6) (i).
33. Sec. 80-F.
34. Sec. 10 (6) (x).
35. Secs. 90 & 91.
36. India has concluded Double Taxation Treaties with Norway,, Sweden, Denmark, West Germany, Germany, Finland, Australia, Japan, Greece and Lebanon, Negotiations are going on with United States, the United Kingdom, Belgium. France and Italy.

incidence of double taxation in the International arena and thus help to attract foreign private capital.

This long list of tax incentives may lead one to believe that foreign private capital would be pouring into the country by taking advantage of these concessions This may be true to a certain extent ; however, there are a number of deterrents in the Indian tax laws which neutralise the effect of these tax incentives.

### Deterrents

The first and foremost deterrent is the high rate of income tax levied on the companies in India. A foreign company has to pay tax at the rate of 70%, which is 15% higher as compared to domestic companies (which is high in itself). The Finance Minister of India, admitted this fact recently,[37] but said that this could not be helped in a developing country. The corporate tax is so high in India, that to earn a net return of 10%, the gross earnings would have to be as much as 30%. Against this, in the United Kingdome the gross earnings of 16.25% would give a net return of 10%, in the United States 19.75%, in France 13.3% and in West Germany 11.5%. Mr. Sundara Rajan, Chairman, Central Board of Direct Taxes, has refuted the fact of high corporate taxation, by pointing out that by taking into account the tax concessions available to foreign investors, the overall incidence of corporate tax in priority industries on these undertakings, having a profitability of 25% of its capital base, would be well below 50.90%, while it is 52.8% in the United States. While Mr. Sundara Rajan is right in his analysis, he has failed to take into consideration the fact that, the foreign investor is concerned with the overall tax structure in the country, and is not impressed by selective tax concessions, and certainly the high rates of corporate taxation in India act as a psychological barrier for him.

Mr. Bhoothalingam in his final report on *Rationalisation and Simplification of the Tax Structure*, has recommended that the rate of tax on foreign companies should be lowered to 60% and on domestic companies to 45%.[38] The recent budget has failed to take this recommendation into consideration. The foreign private investor, it is submitted, would appreciate a more stable tax structure, with less frequent changes and with low rates of tax, than an unstable tax structure riddled with concessions. Tax concessions could still be given wherever desired, but their number would naturally be limited, because of the already low tax rates in the country.

37. This was stated by the Finance Minister in his inaugural address to the delegates of the International Seminar on "Taxation in India and Foreign Private Investment," held in New Delhi, 27th to 29th November, 1968.

38. *Bhoothalingam Report* 33.

The tax incentives mentioned hereinbefore, are more specious than real. "These are short-term bribes for longterm handicapes," is the typical comment of some foreign investors. Many of these incentives have such conditions to be fulfiled before they can be availed of, that the foreign investor is not attracted, *e.g.*, the creation of a reserve to the extent of 75% of the development rebate allowed, which cannot be touched for distribution of dividends by way of profits or for remittance outside India as profits, is a condition which detracts from the effectiveness of development rebate as an incentive, as far as a foreign investor is concerned. The five year 'tax holiday' does not carry conviction, because it is followed by high levels of taxation in subsequent years. Being a profit-oriented concession, it is of least benefit to companies in the earlier years.

In most cases the tax incentives given by India are nullified by the tax laws of the foreign investor's own country, even though there is a treaty for avoidance of double taxation, between his country and India. The foreign countries generally allow a tax credit to their citizens and residents against their own tax liability for the taxes paid in the countries where the income is earned, and not for taxes which would have been paid but for the tax incentive laws of these countries ; in other words, the tax credit is given against the taxes "actually" paid to the foreign country, and not for taxes "spared" in that country due to the tax incentives.[39] Except in the tax treaty with Japan,[40] India has not been able to include a "tax sparing" provision in any other double taxation treaty. In fact the "tax sparing" provision in the draft tax treaty with the United States in 1959, proved the stumbling block to its ratification by the United States Senate, and the treaty never came into effect. This lack of appreciation on the part of the developed countries towards the incentives given by India or other developing countries, is one of the major deterrents to foreign private investments in these countries.

Another deterrent is the presence of such ambiguous phrases "deemed to accrue or arise,"[41] and "business connection,"[42] in the Income-tax Act, which directly affect a foreign private investor. Income "deemed to accrue or arise" in India, is an example of the Income-tax Act trying to catch that income which by no stretch of imagination can "accrue or arise" in India. The concept of "business connection", though not defined in the Act, has been interpreted by the Income Tax authorities and to some extent by the courts too, in such a manner as to rope in income of every

39. See Bijawat, "Tax Sparing—An Instrument to Retain and Attract Foreign Capital," in 6. *J.I.L.I.* 236-252 (1964).
40. Article XI (3) (b).
41. Sec. 5 (1) (b).
42. Sec. 9(1)(*i*)

foreign business concern which has some "connection" in India.[43] This unrealistic method of expanding the "tax net" is certainly not helping to attract foreign private investment. It is suggested that this should be done away with at the earliest.

No developing country can have tax laws which remain static, but frequent changes, as is the practice in India,[44] is not conducive to the general economic development of the country. The Income-tax Act, 1961, has been so badly mutilated in a short span of eight years, by substitutions, insertions and amendments, that it has become as incomprehensible as the Income-tax Act of 1922, which it replaced with a view to making the Income tax law more simple and easy to follow. There should be stability in the tax laws, and only then can a developing country hope to attract foreign capital.

## Conclusion

We have seen that taxation plays a very significant role in the expansion of private enterprise in India. The government is like the operator of a puppet show in this respect, and can regulate private enterprise by pulling the strings of taxation in any manner it likes. But it is desirable that such regulation should work in a way as to encourage investment. Taxes are the price that a civilized society has to pay for the well-being of the community. To that extent they are necessary and inevitable. But if imposed beyond a certain limit, they are bound to stifle private initiative and make the capital shy - the two key factors in the economic progress of any country, and particularly in India at the present stage of development. Taxes in the country have reached the point of saturation, especially in the corporate sector, and any further increase therein will have an adverse effect on the Indian economy.

Taxation and investment go hand in hand, and it is for the Indian Government to see that its tax policies and tax structure are so oriented that they encourage and attract capital - both domestic and foreign - for the economic development of the country. Foreign private investment will not only come if there is a big "Welcome" board, and efforts are made to see that it remains there.

43. For details see Bijawat, M.C., "The Concept of Business Connection—A Deterrent to Foreign Investment," in 19 *Taxation* 114-120 (1965).
44. The latest spate of amendments and changes are contained in the Finance Act, 1969; and The Taxation (Laws) Amendment Bill, 1969, proposes far-reaching and major changes in the Income-tax Act.