NOTE

TAXATION ASPECTS OF FOREIGN INVESTMENTS IN INDIA

I. INTRODUCTION

Results of surveys conducted in different parts of the world leave no doubt that taxation is only one of several factors affecting the flow of foreign trade and investment.¹ The role of taxation, although important in the planning of foreign investment, is secondary to other nontax factors in determining the investment climate of a country. Investments based solely on tax considerations last no longer than the favorable tax climate.² Indeed, the benefits of a favorable tax climate hardly compensate for business risks engendered by an unfavorable economic and political environment. Such risks include the possibility of restrictions on repatriation of profits or on the movement of capital. The possibility of expropriation of the business venture is a more obvious concern. However, once the decision to invest is made, other matters, such as the form of activity as an appropriate mode of investment and the area of activity suitable for investment, should be decided upon only after full consideration of the tax implications of the proposed investment.³ The purpose of this Note is to familiarize the potential foreign investor with Indian tax laws and tax incentives and to assess their impact upon investments in India.

India's tax policy vis-a-vis foreign investment has been influenced greatly by India's attitude toward foreign presence on the sub-continent. Since independence in 1947, the interplay of two factors has been primarily responsible for shaping India's approach to private foreign investment.⁴ On one hand, India has developed a tremendous need for productive capital investment to

² See Hoorn, Foreign Tax and Investment Incentives, in INTERNATIONAL TRADE, INVESTMENT, AND ORGANIZATION 154 (1967).
⁴ M. Kidron, FOREIGN INVESTMENT IN INDIA (1965); M. Kust, FOREIGN ENTERPRISE IN INDIA (1964 & Supp. 1966); Kurk, Foreign Collaboration Agreements: Policy as Law, 9 J. INDIAN L. INST. 1 (1967).
support national savings for planned economic development. Conversely, India also has been suspicious of possible foreign economic domination facilitated by an excessive and unrestricted inflow of foreign private capital.

During the first two decades after independence, a desire for rapid industrialization overshadowed the suspicion of foreign capital. Consequently, throughout the first three five-year plans, foreign public and private capital made a substantial contribution in carrying out various development programs. The total inflow of private foreign capital of Rs 6.25 billion during the three plans amounted to about 25% of the total private sector investment in the industrial field. Most of the investment of foreign private capital was in the form of direct investment.

However, the increased inflow of foreign capital raised the spectre of foreign economic and technological domination. Such concerns for sovereignty coupled with and reflected in wars with China in 1962 and with Pakistan in 1965 and 1971 forced Indian planners to think in terms of self-reliance and self-sufficiency. Thus, it was no surprise that the industrial policy statements of 1973 and 1977 favored employing foreign investment to foster the technological and economic objectives of self-reliance. To realize these objectives, India’s policy toward foreign capital and technology in recent years has been that of "selectivity."

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5 In a special statement made in Parliament in April 1949, Prime Minister Nehru declared that “Indian capital needs to be supplemented by foreign capital not only because our national savings will not be enough for rapid development of the country on the scale we wish, but also because in many cases scientific, technical, and industrial knowledge and capital equipment can best be secured along with foreign capital.” NATIONAL COUNCIL OF APPLIED ECONOMIC RESEARCH, TAXATION AND FOREIGN INVESTMENT 5 (1957).

6 T.T. Krishnamachari, Minister of Commerce and Industry, stated in 1953 that “if we want progress, we must be prepared to use foreign capital in developing our industrial production . . . . If there is to be a choice made between industrialization with foreign capital or no industrialization at all, I must say that I would personally choose the former—industrialization at all costs.” Id. at 6.


8 W. FRIEDMANN & J. BEGUIN, JOINT INTERNATIONAL BUSINESS VENTURES IN DEVELOPING COUNTRIES 312 (1971). Some reasons given by the authors for the great inflow of foreign capital during the period include higher average profits enjoyed by foreign firms, large potential market, a high tariff and protection of indigenous production, access to essential raw materials and international competition to capture new markets.

The main thrust has been to employ foreign capital in high priority and specialized technology sectors as to enlarge and improve the technological base and absorptive capacity of the nation. This element of selectivity is being followed, taking into account the development of indigenous technology and diversification of industrial structure over the years.10

The policy clearly stresses that foreign investment and transfer of technology necessary for India's industrial development are allowed only on terms that, as determined by the government of India, are in the national interest. However, in the several areas where technology gaps exist, foreign investment is needed to supplement domestic capital. In these specified areas, foreign capital and technology have a definite role in accelerating India's industrial progress.11

The emphasis of current foreign investment policy is on financial investment. In India, foreign investment has been viewed as a vehicle for the transfer of sophisticated technology required for development plans. Although the transfer of technology may be accompanied by foreign equity participation, there is a distinct preference for the outright purchase of technology.12

The areas in which foreign investment is permitted are generally restricted to 40% of equity capital.13 Higher foreign equity can be permitted in priority industries involving higher or more sophisticated technology or those which are largely export-oriented. In export-based industries, foreign equity may reach 100%. In priority industries requiring sophisticated technology but catering largely to the domestic market, foreign equity investment may be up to 74%. Foreign companies that were operating in India on the date of commencement of the Foreign Exchange Regulation Act (FERA) were directed to adjust their equity levels in accordance with the above policy. Except for a few companies such as Coca Cola and IBM,14 which decided to close down their operations in India rather than to comply with Indian regulations, all the

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10 Seminar on Trade and Industrial Cooperation Between India and EEC Countries, 6th and 7th February 1979, at 21.
11 GOVERNMENT OF INDIA, MINISTRY OF INDUSTRY, STATEMENT ON INDUSTRIAL POLICY (23 Dec. 1977).
12 Id.
13 Foreign Exchange Regulation Act § 29 (1973). The guidelines issued for implementation of the section are reproduced in H. SINGHAL, TAXING FOR DEVELOPMENT, INCENTIVES AFFECTING FOREIGN INVESTMENTS IN INDIA 56-65 (1975).
14 See Why IBM Must Withdraw from India in June, 24 DATAMATION 181 (1978).
foreign companies (numbering nearly 800) have adjusted their foreign equity in accordance with the new regulations.\textsuperscript{15}

Once the terms of investment and collaboration are approved, companies are permitted complete freedom of outward remittance of dividends, profits, and royalties, as well as complete repatriation of capital. In view of the continuing difficulties experienced by India with regard to foreign exchange, the excellence of its record in the free repatriation of capital and dividends is praise-worthy.\textsuperscript{16}

The joint communique issued after the New Delhi meeting of the Indo-U.S. Business Council (February 2-4, 1976) recognized the new prospects of foreign investments in India.\textsuperscript{17} The communique pointed out that several aspects of the FERA need clarification in order to allay misapprehension about the Act's purpose and impact. The Communique emphasized the need for clarification of Indian taxes and tax incentives applicable to foreign investments.

The Indian tax system, inherited from the British, did not address problems of foreign investment. The sole purpose of the tax laws was to facilitate collection of revenue. After independence, tax laws became a fiscal tool consciously employed to achieve such national objectives as improved mobilization of the country's resources, the refinement of the government's administrative and developmental activities, and the realization of the social objective of reducing inequalities of income and wealth.\textsuperscript{18}

Following the recommendations of the Direct Tax Inquiry Commission (1955), efforts were made to overhaul the existing tax structure to accommodate interests of foreign investors and enterprises. Consequently, the Income Tax Act of 1961 replaced the 1922 Act. The latest effort to update the Indian tax system was the report of the Direct Tax Laws Committee (the Chokshi Committee) in 1978.\textsuperscript{19}

This Note outlines, discusses, and suggests changes in various provisions of the Income Tax Act of 1961 applicable to foreign investments. The discussion initially examines the general underlying principles of the Indian tax system, followed by an examination of the tax liability of foreign personnel in India and of special

\textsuperscript{15} H. Singh, FOREIGN INVESTMENT POLICY OF INDIA, 5 (1979).
\textsuperscript{16} Friedmann & Beguin, supra note 8, at 330.
\textsuperscript{17} 66 E. Economist 296 (1976).
\textsuperscript{18} National Council of Applied Economic Research, Taxation and Foreign Investment 2 (1957).
tax incentives granted to foreign technicians. An analysis of the system of corporate taxation of "resident" and "non-resident" companies and the tax liability of foreign collaborators is then presented. Special attention is devoted to the liability arising out of various trading activities of non-resident companies in India and the many problems of judicial determination relating to such activities. Incentives for investment and savings are also discussed. Finally, the extent to which the United States investor is entitled to tax relief under United States foreign tax credit laws is assessed. The Note concludes with an overall view of the tax impact on foreign investments and the extent to which foreign companies may benefit from India's efforts to attract investments.

II. GENERAL FEATURES OF INDIAN TAX LAWS

In India's federal constitution, the division of legislative powers between the Union and the States is itemized in three detailed lists: List I (the Union List), List II (the State List), and List III (the Concurrent List). The power to tax incomes of individuals and companies, other than agricultural income, is conferred exclusively upon the Union legislature.20

The two basic sources of Indian tax laws are the Income Tax Act of 196121 (ITA) and the annual Finance Acts,22 which fix the tax rates each year. The administration of the income tax is governed by a separate law enacted in 1962. The Income Tax Rules of 1962, as amended in subsequent years, consist of 124 rules and 54 forms. The rules promulgated under the Act have the same force as the sections in the Act.23 The highest tax-executive authority is the Central Board of Direct Taxes, which is constituted under the Central Boards of Revenue Act of 1963. Its powers of administration, supervision, and control extend over the entire Income Tax Department. The circulars or general direc-

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20 Indian Const., Seventh Schedule. List I (the "Union List") enumerates the subjects with respect to which the Union Government has exclusive legislative power. List II (the "State List") enumerates the subjects with respect to which the State Governments have exclusive legislative power. List III (the "Concurrent List") specifies the subjects with which the States may deal in the absence of inconsistent legislation by the Union Government. For a general treatise, see D. Basu, Commentary on the Constitution of India (6th ed. 1978).

21 The new Act was intended to rationalize and simplify the Act of 1922, bringing it into conformity with development planning objectives.

22 The Finance Acts also enact amendments to the basic Income Tax Act. The retroactive application of the Finance Acts was changed in 1967 to prospective application, i.e., it was made applicable to the fiscal year beginning during the current year, April 1 to March 31.

tives issued by the Central Board of Direct Taxes are binding on all officers and persons employed in the execution of the ITA. However, press notifications issued by the government have no legal force.

Income tax cases originate before the Income Tax Officer (ITO). Appeal from the ITO's order may be pursued in the Appellate Assistant Commission (AAC). An additional appeal is available to the Appellate Tribunal (AT), which is the final fact-finding authority. A reference lies to the High Court at the instance of the assessee or the Commissioner on any question of law arising out of any order of the AT. Within sixty days of the AT's order, reference may be made to the High Court in the jurisdiction where the assessee is doing business or where he resides. A final appeal is allowed to the Supreme Court from any judgment of a High Court delivered on a reference, provided the High Court certifies the case as appropriate for appeal to the Supreme Court. Certification is given if the case involves a substantial question of law, if the question is likely to occur in successive years, or if the question is otherwise of great public or private importance. The Supreme Court will not reconsider or overrule its earlier decisions unless they are clearly erroneous. If the High Court refuses to certify a case for appeal to the Supreme Court, an application may be made to the Supreme Court under article 136 of the Constitution for special leave to appeal the High Court's decision. The Supreme Court's decision is final and creates judicial precedent that is binding on the High Courts of all the states. A decision of the High Court is binding in the state in which the court has jurisdiction, but not outside that state. However, in order to achieve uniform construction of law, the considered opinion of another High Court generally is followed unless overriding reasons for taking a divergent view exist.

24 See I.T.A., § 119. In exercising its power to issue a general circular under this section, the Board cannot impose a burden on the taxpayer or otherwise put him in a worse position than he occupies under the statute, but the Board can relax the rigors of the law or grant relief not found in the terms of the statute. Such circulars make for just and fair administration of the law. The Supreme Court accepts the validity and binding nature of such beneficent circulars, and recognizes the taxpayer's right to have them enforced in his favor, even in court.


26 I.T.A. § 246.

27 Id. § 253.

28 Id. § 256.


30 I.T.A. § 261.

A. Chargeability to Income Tax

Section four of the ITA imposes taxes upon every person based on the total income of the previous year; section five defines the extent of total income.\textsuperscript{32} Any discussion of Indian tax law should begin with an examination of section four, the key section of the ITA from which tax liability arises.\textsuperscript{33} The items constituting "income" are specifically enumerated in the definition section of the Act.\textsuperscript{34} The definition is not exhaustive. "Income" includes not only those things enumerated in the definition, but also that which the word signifies according to its natural meaning.\textsuperscript{35} Thus, it is clear that the difference in "source of income" in Indian and in U.S. law is only superficial.\textsuperscript{36} The definition of "person" applies to both individuals and companies.\textsuperscript{37} "Previous year," as defined in the Act, consists of the twelve month period ending on the last day of March of the preceding year.

The scope of the "total income" chargeable to tax is defined under section five of the ITA.\textsuperscript{38} The chargeability of income depends upon the locality of accrual or receipt and the residential status of the "assessee" in India. Citizenship of the assessee is irrelevant for this purpose. An individual may be either a resident, a resident who is not ordinarily resident, or a nonresident, depending upon the period of his presence in India or maintenance of a dwelling in India. A company or a corporation may be in any of these categories.

A resident is taxed on "total world income," which consists of:

(a) income received or deemed to be received in India;
(b) income that accrues or arises or is deemed to accrue or arise in India; and
(c) income that accrues or arises outside India during the

\textsuperscript{32}I.T.A. §§ 4 & 5.
\textsuperscript{33}R. RAI, TAXATION OF NON-RESIDENTS IN INDIA 35 (1967).
\textsuperscript{34}I.T.A. § 2(24). The categories of "income" are: (a) salaries, (b) interest on securities (including bonds and debentures), (c) income from house property, (d) profits and gains of business or profession, (e) capital gains, and (f) income from other sources (not falling under any of the preceding categories). The Income Tax Act of 1961 prescribes in detail the scope and methods of computing income under each heading.
\textsuperscript{36}I.R.C. § 61.
\textsuperscript{37}I.T.A. § 2(31).
\textsuperscript{38}Id. § 5.
previous year, even if the income is not received or brought into India.\footnote{Id. § 5(1).}

An individual \textit{not ordinarily resident} is taxed on foreign income only if it is derived from a business controlled in India or a profession or vocation set up in India, or if it is deemed to accrue in India or is received or deemed to be received in India.\footnote{Id. § 5(1)(c).} A \textit{nonresident} is taxed only on income that is received, that accrues, or that arises in India. Income from investments outside India, if not received in India, will not be taxable to foreigners coming to India for employment for the first ten years, if they remain \textit{not ordinarily resident}.\footnote{Id. § 5(2).} To summarize the general rule, all assessees, whether resident or not, are chargeable for income received, accruing, or arising, or deemed to be received, to accrue or to arise in India. Residents are chargeable for income that accrues or arises and is received outside India.\footnote{J. Kanga & N. Palkhivala, supra note 35, at 161.}

\section*{B. Receipt of Income in India}

Income can be realized either in kind or in cash; that is, what among businesspersons would be equivalent to receipt of a sum of money would be receipt of income within the meaning of the statute.\footnote{Gresham Life Assoc. Society Ltd. v. Bishop, 4 T.C. 464, 476, [1902] A.C. 287; C.I.T. v. Ogale Glass Works Ltd., [1954] A.I.R. 429.} A receipt can be either actual or constructive. Even where no money is exchanged, such as in an adjustment of a cross claim, a settlement in account, an exchange effected by a book entry, or a setoff, the receipt is considered actual.\footnote{Trinidad Lake Asphalt Operating Co. v. C.I.T., [1945] I.T.R. Supp. 14.} A receipt is constructive when received through an agent, such as a bank or broker or any person or sales agent authorized to collect and discharge.\footnote{Periera and Roche v. C.I.T., [1966] 61 I.T.R. 371.} It is important to note that the first receipt determines the year and place of taxation. A nonresident is taxed on foreign income only when it is received in India for the first time from the foreign source. The foreign income received abroad, even though later remitted to India, is not taxable.\footnote{C.I.T. v. Mathis, [1929] 7 I.T.R. 48, 55, 56.}

A special problem arises in a case where income is received through payment of a check sent by mail. Indian courts have held
that the place of receipt is where the check is mailed, provided the mode of sending is adopted at the express or implied request of the recipient. In such cases, the post office is treated as the agent of the addressee. Otherwise, the place of receipt is where the check is delivered to the addressee. The soundness of such a conclusion is questionable. Some have contended that irrespective of an implied or express request, receipt by the post office should not be treated as the first receipt of the income on behalf of the assessee. Such an interpretation not only burdens courts with the problem of determining the agent's role and functions, but also imposes tax liability upon foreigners whose perhaps recent arrival in India prevents the receipt outside India of income actually earned outside India. Also, considering the fact that at the time foreigners earned the income in another country there may have been no nexus with India, the mere subsequent entry into India should not make the foreign income taxable. A clear statement of policy in this regard from the Central Board of Revenue may be required to eliminate the confusion. Another way to overcome the problem is for the parties to stipulate in an express agreement that the payment should be made at a certain place, and that the check is to be received at that place. The income is considered to be received at the agreed location and the issue of whether the check was mailed at the recipient's request is avoided.

C. Accrual of Income in India

Because a foreigner's income tax liability depends upon whether the income accrues in India, determination of time and place of accrual is important. Income is held to accrue at the date when a debt becomes due. Indian courts have employed considerable flexibility in deciding the place of accrual of income. Thus, in a contract of sale, income accrues at the time and place that the title to the goods passes from the seller to the buyer ac-
according to the particular facts of the case. A commission paid for services accrues at the time and place where the services are rendered.\(^5\)

Where an assessee sells goods of his own manufacture, profits do not accrue solely where the sales take place, but must be apportioned between the place where the goods are manufactured and the place where they are sold.\(^5\)

D. **Deemed Accrual of Income in India**

Certain categories of income are deemed to accrue or arise in India and are amenable to tax for all categories of persons, whether resident or nonresident.\(^5\)\(^4\) These include income accruing or arising from the following sources: any business connection in India; property in India; money loaned on interest and brought into India; any asset or transfer of capital asset situated in India; dividends paid by an Indian company outside India; payment of royalties and technical fees by an Indian company or by an Indian source; and, any salaries earned in India. These categories of income are discussed in detail in the next section of this paper.

**III. Taxation Of Foreign Personnel And Technicians**

An important objective of India's current industrial policy is the promotion of technological self-reliance. To achieve this objective, the Indian government recognizes the necessity for a continued inflow of technology in sophisticated and high priority areas in which Indian skills and technology are not yet adequately developed.\(^5\)\(^5\) Any foreign investment in sophisticated and high priority areas naturally brings foreign technicians to India. The high rate of taxation on personal income, however, deters foreign companies from locating personnel in India, thus adversely affecting the desirability of investment in India.\(^5\)\(^6\) To overcome this difficulty and to make available to Indian industry the special knowledge and experience of foreign technicians, various tax exemptions have been granted to foreign technicians.\(^5\)\(^7\) This section

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\(^5\) \(\text{I.T.A. } \S 9. \) See part IV infra.


discusses the general scheme of personal taxation and focuses on the tax incentives offered to foreign technicians.

A. *Foreign Personnel*

The incidence of personal income taxation varies with the residence of the assessee. The residential status of the assessee is determined by the technical test of territorial connection amounting to residence.58 A person is either a *resident*, a *resident but not ordinarily resident*, or a *nonresident*.59 If a foreign person qualifies as a resident, a further inquiry is made to determine if he also qualifies as resident but not ordinarily resident, in which case he is entitled to a partial exemption not otherwise available.60 As a result, although a single rate of personal taxation applies to all three categories of assessees,61 under the scheme of personal taxation, the incidence of tax generally is highest for residents who are ordinarily resident, lower for residents who are not ordinarily resident, and lowest for nonresidents.

Foreign personnel generally fall into the category of resident but not ordinarily resident or nonresident and enjoy numerous exemptions under section ten of the ITA,62 which reduces the tax

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58 The tests are artificial—staying for a day more or less may make all the difference—but they make for precision and certainty, and were held valid and *intra vires* under the 1922 Income Tax Act. See Wallace Bros. & Co. Ltd. v. C.I.T., [1948] 16 I.T.R. 240, 246.

59 I.T.A. § 6. For purposes of this Act:

1. An individual is said to be a resident in India in any previous year, if he
   (a) is in India in that year for a period or periods amounting to one hundred and eighty-two days or more; or
   (b) maintains or causes to be maintained for him a dwelling place in India for a period or periods amounting to one hundred and eighty-two days or more in that year, and has been in India for thirty days or more in that year; or
   (c) was, within the four years preceding that year, in India for a period or periods amounting to three hundred and sixty-five days or more.

2. A person is said to be "not ordinarily resident" in India in any previous year if such person is
   (a) an individual who has not been resident in India in nine out of the ten years preceding that year, or has not, during the seven years preceding that year been in India for a period of, or periods amounting to, seven hundred and thirty days or more; or
   (b) a foreign individual not qualifying as resident or not ordinarily resident is considered a nonresident.

Id.

60 If a foreign individual is found to be a resident, then the only further question arising is whether he is not ordinarily resident, and as such is entitled to the exemption in the proviso to I.T.A. § 5(1)(c).

61 Taxpayers other than companies pay income tax on the basis of a schedule of progressive rates graduated into brackets of income. This schedule is prescribed by the Parliament annually through the Finance Act.

burden and encourages foreigners to invest funds and to engage in activities in India. For example, the scheme encourages a nonresident to invest in securities and bonds by exempting the income from interest on such investments. Saving is encouraged by exempting the income earned from interest on deposits under nonresident (external) accounts. Total tax exemption is given to remuneration earned on a foreign ship and from employment by a foreign government or a foreign philanthropic organization. Also, sums received for teaching in educational institutions and for research work in India enjoy total tax exemption.

Subject to the conditions stated in section ten of the ITA, remuneration received by employees of a foreign enterprise for services rendered in India is tax exempt. This provision also exempts from taxation the foreigner on a short visit to India to investigate investment prospects. However, if the stay exceeds ninety days or fails to meet the other aforementioned criteria, the foreigner becomes liable for tax on the income he receives in India or which accrues or arises in India, or which is deemed to be received or to accrue or arise in India. However, income accrued or received outside India is still excluded. A ninety-day limitation is a very short period for a foreigner to investigate investment possibilities, especially in view of the fact that negotiations and procedural matters often move rather slowly in India. The Chokshi Committee wisely recommended that the law be amended to vest power in the central government to extend the ninety day period in appropriate cases.

Complications may arise if a foreigner's income received or accrued outside India is considered a salary earned in India because such income is deemed to accrue or arise in India and is taxable. This has very important implications for the foreigner working in India. Because even salaries paid outside India for employment in India are subject to income tax liability and because salaries in the United States and Europe typically are much higher than in India, such income falls into a higher income tax rate. The tax burden is lessened to some extent, however, by

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83 I.T.A. § 10(4).
84 Id. § 10(4A).
85 Id. §§ 10(6)(viii), 10(6)(xi), 10(6)(vi-a).
86 Id. §§ 10(6)(ix), 10(6)(x).
87 Id. § 10(6)(v).
88 Id. § 5(2).
89 See RECOMMENDATIONS OF THE DIRECT TAX LAWS COMMITTEE (The Chokshi Committee) ¶ 1-4.8 (1978).
90 I.T.A. § 17(1).
91 Id. § 9(1)(ii).
the fact that this tax may be used to offset income taxes in the employee's home country. Thus, it becomes necessary to examine how Indian courts have interpreted the term "salary earned in India." Salary is earned in India when it accrues in India. Salary accrued for services rendered by a foreigner in India is salary earned in India. The place of contract of service or of receipt outside India makes no difference. One should note, however, that where the contract is not of service but rather a contract for services, the earning may qualify as "professional income," which, if accrued outside India, would not be taxed in India.

A contract is for services if the employment is incidental to the exercise of a profession. The earnings from such employment would be considered professional income and not salary. For instance, earnings of a professional actress for appearing in a play or film is income arising from the exercise of her profession and is not taxable as salary. On the other hand, income of a person who occupies a regular post or office amounting to service is taxable as salary because such employment is distinguishable from a mere engagement in the course of a profession.

B. Foreign Technicians

The impact of tax liability is narrowed considerably if the foreign individual qualifies as a "foreign technician" under ITA section 10(6)(vii-a). To qualify as a technician, a person who is not a

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73 Two variations of this problem exist: (1) where a foreigner is managing his employer's business in India as well as in other countries, that part of his salary paid for work done in other countries should be clearly bifurcated by the employer. Also, salary not related to businesses in India should not be received by a foreigner in India. In such a case, it can be contended that the salary relating to other countries is not taxable in India; and (2) office and other expenses of a foreigner should not be paid to him as salary, but as a specific allowance to meet the cost of expenditures incurred in the performance of official duties. Such an allowance, to the extent of expenses incurred for official duties, would not be taxable in India. For a detailed discussion, see H. Agrawal supra note 72, at 150, 188.


76 See Mitchell & Edon v. Ross, 40 T.C. 11.

77 I.T.A. § 10(6)(vii). This section applies to "technicians" who commenced their services in India before 1 April 1971, while I.T.A. § 10(6)(vii-a) applies to "technicians" who commenced their services in India after 31 March 1971. This discussion is confined to the "technicians" described in I.T.A. § 10(6)(vii-a). For a discussion of the "technicians" under I.T.A. § 10(6)(vii), see H. Agrawal, supra note 72, at 151-52, and R. Rai, supra note 33, at 62-63.

78 Berarwalla, Tax Relief to Foreign Technicians, 69 E. Economist 925 (1977).
citizen of India must have specialized knowledge and experience in one of the following areas: construction or manufacturing operations, mining, the generation of electricity or any other form of power, agriculture, animal husbandry, dairy farming, deep sea fishing, or shipbuilding. To qualify for an exemption, a foreign technician must fulfill the following conditions:

1. an application for the approval of the contract of employment must be made to the Central government before the commencement of the services or within six months after commencement;
2. the employment must be in the government or local authority, or in a corporation set up under any special law, or in any such institution or body established in India for scientific research approved by the prescribed authorities, or in any business carried on in India; and
3. the foreign individual must not have resided in India in any of the four tax years immediately preceding the year of arrival in India.

The requirement of government approval of the employment contract of a technician gives the central government plenary authority to determine whether a particular foreigner possesses the required knowledge and experience. This enables the government to control the entry of foreign personnel and to promote the objective of encouraging technical training of Indians by restricting the number of foreign personnel classified as technicians.

For the first two years, the maximum amount of tax exempt

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79 H. Agrawal, supra note 72, at 404. The Central Board of Direct Taxes has issued guidelines in this connection, referred to in circular O.M.F. No. 22/26/66-IT (A) (16 Nov. 1966), which state that the deciding factor for the exemption is not the designation of the post held by the foreigner, but the possession of specialized knowledge and experience in the course of his duties, and the employment of the person in a capacity in which such specialized knowledge and experience are actually utilized. Part D of the Annex to the circular discussed above mentions the guiding principles followed by the Ministry of Industry in the matter of according approval in the cases of foreign technicians. The principles are:
   (i) whether the employment of the foreign technician is considered essential; if so, for what period;
   (ii) whether services of such a person are readily available in the country;
   (iii) whether the emoluments proposed to be given to the foreigner are in keeping with his qualifications and experience;
   (iv) whether he can be considered a technician, in terms of I.T.A. § 10(6)(vi)(a)(ii) (1961); and
   (v) whether approval for the employment of the technicians has been obtained at the appropriate level.
80 An Indian court ruled that a foreign technician need not remain in the same employment during the period of 24 months in order to be entitled to the tax exemption. C.I.T. v. E. Hiller, [1977] 107 I.T.R. 492.
remuneration is Rs 4,000 per month (approximately $533).\textsuperscript{62} Earnings over this amount are subject to taxation. However, the tax may be paid by the employer without being added to the income of the technician during the first two years. The exemption may be extended for an additional two years if the employer has paid the taxes and approval is granted by the central government. Thus, notwithstanding the restriction imposed on the amount of remuneration exempt from tax, the foreign technician may not have to pay any tax, even if his salary exceeds Rs 4,000 per month.\textsuperscript{63}

The extent of incentives afforded foreign technicians, though quite adequate, requires greater flexibility as to the length of time in which incentives are available. The duration of tax exemption may be adequate if the technician is dealing with a specific problem, but may not be adequate if the technician is engaged in overall technical administration, such as supervision of the operations of a newly-established plant. The government’s reluctance to liberalize the provisions of exemption is based on two factors: first, granting more incentives may cause dissatisfaction among Indian technicians, and second, foreign companies may be tempted to use the services of foreign technicians for longer periods than necessary, thereby neglecting the recruitment and training of Indian technicians.\textsuperscript{64}

United States citizens and resident aliens employed in India can reduce their tax liability under United States tax laws, under which worldwide income of the individual is taxed. A United States citizen or resident alien who is either a bona fide resident or who remains in another country for 510 days during a period of 18 consecutive months can exclude from gross income up to $15,000 of “earned income” from “sources without the United States.”\textsuperscript{5} Thus, a United States technician working in India for seventeen months enjoys the tax benefits of both United States and Indian laws and is free of the taxes of both countries for this

\textsuperscript{62} There are approximately 7.8 rupees to the dollar. For the purpose of applying the ceiling of Rs 4,000/month, all items of income chargeable under the heading of “salary” are to be taken into account. See the press note issued by the Ministry of Finance (Department of Revenue & Insurance) on 31 Dec. 1972, reprinted in H. AGRAWAL supra note 72, at 407. See also C.I.T. v. Calcutta Stock Exchange Association, Ltd., [1959] 36 I.T.R. 22, where it was observed that the term “remuneration” is broader than “salary” and should include salary, compensation, rewards, or other payments for the employment.

\textsuperscript{63} I.T.A. § 10(6)\textsuperscript{viva\textsuperscript{A}(A).

\textsuperscript{64} Kapoor, Foreign Collaboration in India: Problem and Prospects, 10 IDEA 213, 242-44 (1968).

\textsuperscript{5} I.R.C. § 911 (1954).
limited period. Also, the portion of Indian tax on the amount above $15,000 is deductible or creditable against the United States income tax.\textsuperscript{85}

In conclusion, exemptions provided to foreign technicians are an important incentive for industrial development in that they lower the total cost of employing foreigners whose specialized knowledge of industry is necessary to India's continued industrial progress.

IV. CORPORATE TAXATION\textsuperscript{87}

Development of the corporate sector, which promotes growth and generates employment, depends largely upon the internal generation of resources, which in turn depends upon the level of profit and rate of taxation. Higher corporate tax burdens result in less savings for reinvestment. Likewise, shareholders receive smaller dividends, thereby rendering equity investment unattractive. The ultimate result is inadequate formation of capital.

Corporate tax in India is very high\textsuperscript{88} and severely reduces a company's retained profits.\textsuperscript{89} Although the tax burden on companies has stifled economic development, efforts to streamline corporate taxation have not been very encouraging to foreign investors.

A corporation in India has to pay two major taxes on its income: income tax and surtax. These regular taxes are supplemented by a capital gains tax on the sale and transfer of short-term and long-term assets.\textsuperscript{90} Any body incorporated under the law of any country is now treated as a company for income tax purposes.\textsuperscript{91} A company

\textsuperscript{85} Tax Reforms Act, 1976, § 1011.

\textsuperscript{87} For the evolution, structure, administration and effects of the taxation of corporate income in India, see S. Ambirajan, THE TAXATION OF CORPORATE INCOME IN INDIA (1964). See also Chakravarty, Tax Burden on Corporate Sector, E. ECONOMIST 747 (1977).

\textsuperscript{88} The effective maximum corporate rate, including surcharge, applicable to public as well as private companies was 43.4% in 1951-52. This has been gradually raised and is currently 57.75% for widely held public companies and 68.25% for closely held companies. The tax rate applicable to foreign companies is 73.5%. In addition, the companies also have to pay a 25% surtax on their chargeable profits between 10-15% of capital, and a 40% surtax on the profits exceeding 15% of capital. Taken together, the two taxes increase the tax incidence on companies, particularly private companies, to 75%. This incidence is reflected in the increasing revenue derived from corporate taxation. The revenue amounted to Rs 1.1 billion in 1960-61, and is estimated at Rs 7.7 billion for 1975-76. In a period of about 15 years, the tax yield from corporations has increased by 700%. See 65 E. ECONOMIST 793 (1975).

\textsuperscript{89} Id. Retained profits as a percentage of profits before taxes were 27.5% in 1970-71, 23.5% in 1971-72, and 20.8% in 1972-73.

\textsuperscript{90} Chakravarty, Tax Burden on Corporate Sector, 69 E. ECONOMIST 747 (1977).

\textsuperscript{91} I.T.A. § 6(3)(i).
or corporation is resident in India if it is registered in India and if during the tax year the control and management of its affairs is located in India. A nonresident company is treated as a resident company for the purposes of tax if it has made arrangements for the declaration and payment of dividends within India as provided under Rule 27 of the Income Tax Rules of 1962. Most foreign subsidiaries either are incorporated in India or comply with the requirement under Rule 27. A nonresident company is taxed at a higher rate than a resident company. This policy is designed to compensate for the loss of revenue on dividends declared by such companies outside India from profits earned in India and paid to nonresident shareholders not subject to Indian tax.

Resident companies are taxed on their worldwide income at rates that vary according to their ownership and activity. Tax rates are higher for closely-held than for widely-held companies, higher for companies in non-priority industrial sectors and higher for trading and investment concerns than for industrial companies. Tax rates also vary between size and type of taxable incomes. A nonresident company, for example, pays higher rates on all income, other than on income derived from government approved royalties and technical services.

A. Taxation of Resident Companies

1. Income Tax

The present corporation tax is levied at the general rate of about 55% on the taxable profits of corporations computed as gross income, including nondeductible expenses less certain ex-

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92 I.T.A. § 6(3)(k)(ii).
93 Id. § 80B(2).
94 J. KANGA & N. PALKHIVALA, supra note 35, at 513. Rule 27 prescribes arrangement for declaration and payment of dividends which may be summarized as follows:

(i) The share-register of the company for all shareholders shall be regularly maintained at its principal place of business within India, in respect to any assessment year, from a date not later than the first day of April of such year.

(ii) The general meeting for passing the accounts of the previous year, relevant to the assessment year, and for declaring any dividends in respect thereof shall be held only at a place within India.

(iii) The dividends declared, if any, shall be payable only within India to all shareholders.

95 H. SINGHAL, supra note 13, at 12.
96 INDIA INVESTMENT CENTRE, TAXES AND INCENTIVES, 10-14 (1978-79) [hereinafter cited as TAXES AND INCENTIVES].
97 H. SINGHAL, supra note 13, at 11.
empt income. Unlike most other taxpayers, a corporation incurs tax liability on its taxable income, regardless of amount.

2. **Surtax**

The Companies (Profits) Surtax Act of 1964 imposes a special levy on the profits of corporations. Surtax is levied when total taxable income of a corporation, after certain specified deductions, is higher than 15% of the capital base or a sum of Rs 200,000, whichever is higher. Effective assessment year 1972-73, the surtax is leviable at a rate of 25% on the amount of excess up to 5% of the capital. The remainder is taxed at the rate of 40%. The following examples illustrate the computation of surtax in the case of domestic companies. In the examples it is assumed that:

1. a domestic industrial company has a net worth (paid-up capital plus development rebate reserves, investment allowance reserve, and reserves created out of taxed profits) of Rs one million;
2. the company earns a profit (before tax but after deduction of depreciation) of 40% of its net worth; and
3. the company has no income exempt from surtax (such as capital gains and inter-corporate dividends).

The surtax liability will be as follows:

(A) Where the company is not entitled to benefits such as investment allowances and income tax holidays: profits

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98. The main items of such exempt income are (a) capital gains; (b) dividends received from a domestic company; (c) income from any new industrial undertaking exempt under the income tax holiday provision; (d) interest on tax free securities of the government; (e) royalties received from the government, a local authority or any Indian concern; (f) any income accruing to a foreign company in India by way of interest on loans or technical services fees; (g) donations, to the extent they qualify for relief under the I.T.A.; (h) certain amounts transferred to reserves, by banking companies; and (i) the net income tax payable by the company after making allowance for any relief, rebates or deductions admissible to the company in respect to income tax (which is deducted from the balance of total income). See *Taxes and Incentives*, supra note 96, at 19-20.

99. *Id.* Individual taxpayers incur no liability on income up to Rs. 10,000.

100. *Id.* at 22. The capital base for computing the exempted portion on return of capital, before levying surtax, includes the following: (a) paid-up share-capital (equity preference shares, etc.); (b) premiums received in cash through issuance of shares; (c) development rebate reserves; (d) reserves established by a company from taxed profits; (e) debentures; (f) loan capital; (g) loans from banks, borrowed over a period of 7 years; (h) amounts borrowed from outside India, to be repaid after 7 years.

101. *Id.* Here the calculation is based on the surcharge rate effective 1980-81, *i.e.*, 7.5%. See also H. Singhal, *supra* note 13, at 99-101. His computations show that no surtax is paid by a company in its early years.
total income) .................................. Rs 600,000
less income tax at 55% plus surcharge
at 7.5% ........................................ Rs 354,750
chargeable profits ............................ Rs 245,250
less statutory deduction at 15% on Rs one million or Rs
200,000, whichever is greater .................. Rs 200,000
Rs 45,250
surtax at 25% .................................... Rs 112,125
effective rate of surtax on profits of Rs 600,000 . . . 1.87%

(B) Where the company enjoys investment allowances as
well as tax holidays, profits would be reduced to an
amount less than the statutory deduction. Further
calculations are not necessary to show that there will be
no surtax liability in such a case.

3. Capital Gains Tax\(^{102}\)

Exemption from tax on capital gains is granted either partially
or entirely in specific circumstances in respect to certain cate-
gories of transfer,\(^{103}\) such as housing property,\(^{104}\) residential prop-
erty,\(^{105}\) agricultural land,\(^{106}\) and immovable property of an in-
dustrial undertaking.\(^{107}\)

Capital gain on the transfer of a short-term capital asset (a
capital asset held for not more than thirty-six months before and
after assessment year 1978-79 immediately preceding the date of
its transfer) is taxed in the same manner as income other than
capital gains.\(^{108}\) The tax rates on capital gains arising out of the
transfer of a capital asset other than a short-term capital asset are
as follows:

Assessment years 1977-78 and 1978-79
(A) capital gains relating to buildings or land, or any rights in
building or land:
(1) where the company is a company in which the public
has a substantial interest, and the total income of the
company, other than the long-term capital gain, does
not exceed Rs 100,000 ......................... .40%
(2) in any other case .......................... .50%

\(^{102}\) I.T.A. §§ 45-55. A capital gains tax was first introduced in 1947, at which time the
government concluded that such gain represented an unearned increment. It was abolished
in 1949 and reintroduced in 1957.

\(^{103}\) Id. § 47.

\(^{104}\) Id. § 53.

\(^{105}\) Id. § 54.

\(^{106}\) Id. § 54B.

\(^{107}\) Id. § 54D.

\(^{108}\) TAXES AND INCENTIVES, supra note 96, at 15.
Various incomes are exempted specifically from capital gains tax, including:

1. Capital gains arising from the transfer of a long-term capital asset are exempted, if the full value is invested or deposited in shares, bank deposits, the Unit Trust of India or debentures specified by the government, within six months after the date of the transfer. However, capital gain made by the liquidator of a company on the sale of the company's assets with the object of distributing the sale proceeds among the shareholders is taxable to the company.

2. The distribution of assets by a company to its shareholders upon its liquidation is not capital gain. However, capital gain made by the liquidator of a company on the sale of the company's assets with the object of distributing the sale proceeds among the shareholders is taxable to the company.

3. The Finance Act (No. 2) of 1967 made provision for the tax-free amalgamation or merger of companies. The amalgamating company must be an Indian company.

4. Bonus shares or stock dividends attract capital gains tax at the time of sale or transfer and not at the time of issue.

The tax on capital gain has been criticized as being anti-investment and irrational. Opponents of the tax contend that the capital accretion is automatically taken care of by increasing the gross national wealth, and that the government is directly benefited by increased tax revenue as a result of this augmented income. In response to this criticism it should be noted that since capital gains are treated at a concessionary rate relative to other income, the tax serves as an inducement to obtain income through capital appreciation. The tax on capital gains also provides the government with more revenue to bring about a horizontally equitable tax system.
4. **Tax on Inter-corporate Dividends**

Under the Income Tax Act, the parent (or a holding) company and its subsidiary company are assessed as separate entities for purposes of payment of taxes and therefore are taxed separately. When a parent company receives dividend income from its subsidiary, the parent company is liable for taxation on such income. For dividends paid by one Indian company to another, the allowable deduction is normally 60%, resulting in an effective rate of 22-28% (depending on corporate tax category), plus a 7.5% surcharge. For new affiliates producing fertilizer, cement, pesticides, and paper the allowable deduction is 100%, resulting in no tax on dividends.\(^{\text{118}}\)

Tax also is imposed on undistributed profits of closely-held companies (i.e., companies in which the public is not substantially interested) if they fail to distribute a prescribed percentage of net profits. The minimum statutory percentage of distribution of profits is 45% of profits attributable to certain specified industrial activities and 60% of profits from any other business, except that of an investment company. For investment companies, the statutory amount is 90%. An additional amount of income tax on the undistributed profits of closely-held non-trading companies is imposed at a rate of 25%, 37% in the case of trading companies, and 50% in the case of investment companies.\(^{\text{119}}\)

B. **Taxation of Nonresident Companies**\(^{\text{120}}\)

Nonresident companies are taxed only on Indian-source income; that is, income which accrues or arises in India or which is deemed to accrue or arise there, and income which is received or deemed to be received in India. This generally comprises the following payments:

1. initial lump-sums expended in the transfer of rights in any technology or in imparting information;
2. royalties;
3. fees for technical services;

\(^{\text{118}}\) I.T.A. § 80(M).

\(^{\text{119}}\) Id. See also Taxes and Incentives, supra note 96, at 17.

\(^{\text{120}}\) Taxation of a nonresident company in India is provided under § 9(1)(iv)(v) and (vii) as amended by the Finance Act, 1976.
(4) dividends on shares allotted to foreign participants in lieu of technical know-how services; and

(5) payment of interest on money loaned and/or outstanding balance for supply of machinery, etc.

All these items are excluded from chargeable profits and, therefore, exempt from surtax. The incidence of surtax on nonresident companies is negligible.

1. Taxation of Lump-Sum Payments

Lump-sum payments usually are paid by an Indian collaborator to acquire technology from a foreign counterpart under a collaboration agreement. These payments differ from royalties, which are recurrent payments based on production or sale.

The term “lump-sum” is not defined in the Income Tax Act. However, while defining the term “royalty,” the Act specifically provides that royalty includes any lump-sum consideration. It is, therefore, reasonable to infer that the lump-sum consideration is only a form of royalty, the practical difference being that royalty generally is a recurrent payment based on production or sales while lump-sum payment is a predetermined amount paid to acquire technology, irrespective of production or sale. Any lump-sum payment received by a nonresident company for the transfer of information outside India, including any data, documentation, drawing or specification, relating to any patent invention, model, design, secret formula, process, or trademark is taxed at a rate of 20%. Any other payment not falling within this provision is considered a royalty payment and is taxed at the rate of 40% of the gross amount.

If the lump-sum is received for transfer of technical know-how inside India, the rate of tax is 40%. If an agreement provides for transfer of know-how outside India as well as for services in India, the payment relating to the transfer of know-how should be termed as “lump-sum consideration” (taxed at the rate of 20%) and should not be confused with royalty payments (taxed at the rate of 40%).

121 I.T.A. § 9(1)(vi), explanation 2.
122 H. Agrawal, supra note 72, at 106.
123 No expense of any kind, whether incurred in India or outside India, is allowed as a deduction out of the lump-sum consideration, which is presumed to represent total taxable income in India chargeable at the rate of 20%. Where, however, a foreign participant is not a company, the tax rate of personal taxation is applicable and expenses incurred are deductible. There is no ceiling on the claim of expenses except those falling in the category of head office expenses, which is restricted to 5% of the income. I.T.A. § 44C and 44D.
124 Id. § 115A.
An important point that should be noted here is that ITA does not provide a general definition of "income." However, it does distinguish revenue receipts from capital receipts. Because only revenue receipts are taxable as income, it is necessary to determine whether a lump-sum payment is a revenue receipt. In the past, each case has turned upon its own facts and therefore no definite criteria have emerged. That the receipt is a periodic receipt or a single receipt is of no consequence in determining its nature. However, some of the situations in which the courts have characterized the payment as revenue receipt include those where the payment arises out of a transaction that pertains to the assessee's line of business, or where the owner of the technical know-how gets a lump-sum payment for imparting the know-how to others without substantially reducing its value to himself, or where persons trade in know-how.

2. Taxation of Royalty Payments, Fees for Technical Services, Dividends/Share of Profits, Payment for Supply of Machinery and Other Equipment, and Interests

"Royalty" means consideration for the transfer, or any services connected to the transfer, of patents or copyrights. If the licensing agreement is entered into and the royalties are payable outside India, the royalty income arises in India because the patent is used within the country. Even if the royalty income is not considered to arise in India, it might still be deemed to arise in India under the provision of section 9(1)(i). Patents and copyrights qualify as "property" or assets or sources of income in India. Thus, all income accruing or arising from such patents or copyrights, whether directly or indirectly, is deemed to accrue or arise in India. However, even if such royalties are not derived from property or assets or sources of income in India, the Indian courts have held that the grant of a conti-

125 The Indian tax law draws a distinction between capital receipts or expenditures on the one hand and income receipts or revenue disbursements on the other. In general, only income receipts are included in taxable income, and only revenue disbursements may be deducted. The criteria for distinguishing the two categories have been largely judicially developed and are discussed in J. Kanga & N. Palkhivala, supra note 35, at 104-159. See also Central Board of Direct Taxes, Circular No. 21 of 1969, July 9, 1969, reprinted in H. Agrawal, supra note 72, at 378.

126 Broadbridge v. Beattie, 26 T.C. 63.


nuing license to an Indian licensee creates a business connection in India.130

Forty percent of the gross amount of the consideration (including any lump-sum consideration) for rendering any managerial, technical, or consulting services131 (including the provision of services of technical or other personnel) received by a foreign company is charged as tax. Such consideration is subject to allocation because the services usually are rendered both inside and outside of India.

The value of the shares allotted to the foreign collaborators, in consideration of technical know-how or otherwise, is taxable in India as if consideration were received in a form other than in shares. Dividends received by foreign companies on their equity shares in an Indian company are taxed at a flat rate of 25%. Profit sharing by a nonresident company in partnership with an Indian firm is taxed at the rate of 73.5%.

Profit relating to supply of machinery and other equipment is taxable at a rate of 73.5% only if there is a "business connection" between the nonresident company and its Indian counterpart. Generally, if the equipment is supplied and paid for outside India and if the transaction is on a principal-to-principal basis, there is no business connection and no profit is taxable in India.132 Expenses, subject to restrictions on head office expenses, are deductible.133

The law on taxation of interest paid to a nonresident has undergone a substantial change with the amendments to section nine of the ITA by the Finance Act of 1976. The effect of these changes is that the interest received by a nonresident is taxable in India if the interest is paid by a company or person who is a resident in India. It is immaterial whether the money has been brought into India or used in India. The amendments have widened the tax net to cover interest payable on all monies borrowed outside India.134 The tax payable on income arising as interest is 73.5%, minus deductible expenses.

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131 I.T.A. § 9(1)(vii).
133 I.T.A. § 44C.
134 H. Agrawal, supra note 72, at 115. The intra vires of imposing tax liability on nonresidents under Section 9(1)(v)(vi) and (vii) has been questioned by leading commentators. Two experts state that:

Unlike the residence of the assessee himself, the residence of the person from
3. Other Business Dealings

In addition to tax liability on income arising out of transactions of the types discussed above, a nonresident company may be liable for taxes on income arising out of dealings in or with India provided there exists a "business connection" in or with India.\textsuperscript{135} The test for ascertaining a "business connection" is, in the words of Judge Rangnekar,

\begin{quote}
that there should be a business in British India and a connection between a nonresident person or company and that business and that the nonresident person or company has earned income through such connection.\textsuperscript{136}
\end{quote}

The categories of situations constituting a business connection are not subject to exhaustive enumeration. Examples of business connections, according to leading commentators,\textsuperscript{137} include:

1. maintenance in India of a branch office for the purchase or sale of goods or transacting other business;\textsuperscript{138}
2. establishment of a factory in India in which the raw materials purchased locally are worked into a form suitable for export abroad;\textsuperscript{139}
3. appointment of an agent (who may not be the sole agent)\textsuperscript{140} in India for the systematic and regular purchase of raw materials or other commodities, or for sale of the nonresident's goods, or for other business purposes;
4. formation of a local subsidiary company to sell the products of the nonresident parent company;\textsuperscript{141}
5. close financial association between a resident and nonresident company; and
6. the grant of a continuing license to a resident company.\textsuperscript{142}

\footnotesize
whom the income is received can never afford a sufficient, a real or pertinent territorial nexus to justify the levy of income tax on a foreigner in respect of his income which has nothing to do with India. Under these clauses the foreigner is made liable to Indian income tax in every case in respect of interest, royalty or technical fees received wholly abroad.

J. KANGA & N. PALKHIVALA, supra note 35, at 209.

\textsuperscript{130} I.T.A. § 9(1)(k).


\textsuperscript{132} J. KANGA & N. PALKHIVALA, supra note 35, at 200-01.


\textsuperscript{134} Rogers Pyatt Shellac v. Secretary of State, [1933] 1 I.T.R. 363.


\textsuperscript{136} C.I.T. v. Remington Typewriter Co., (Bombay), Ltd., [1931] 5 I.T.C. 177. As regarding non-Indian subsidiary the position is not clear. For discussion, see M. KUST, supra note 129, at A-20.

The wide and uncertain application of the concept of “business connection” has provoked attacks by Indian scholars and tax consultants. Because the ITA does not define “business connection,” one must turn to the case law for illustrations and indications of the factors considered by courts in defining its scope. Much of the uncertainty involved in the application of the concept has been removed by judicial opinions in recent cases and by comprehensive clarifications issued by the Central Board of Direct Taxes.

C. Summary

A comparison of the effective rate corporate tax in India with other countries shows that taxation of domestic corporations in India ranks third highest (57.75%), with the only higher rates in Iran (63.3%) and Pakistan (60.0%). A reduction in corporate taxes would enable companies to retain larger profits and would improve their growth prospects. The base of surtax corresponds closely to capital effectively employed and prevents more effective use of capital. The concessional treatment of inter-corporate dividends provides only limited relief from multiple taxation of the same income.

The government of India should consider reducing the corporate tax to a reasonable level (perhaps 50%) and reducing the impact of the surtax. This would improve corporate savings, investment, and growth. Experience has shown that the corporate sector’s marginal savings rate is much higher than that of the government. As such, money left in the hands of companies has greater potential for investment than does money controlled by the government.

The Finance Act of 1976 brought about a basic change in assessment of nonresidents. The Act states that interest, royalty, and technical fees are deemed to accrue or arise in India, and thus taxes the nonresident recipient in cases where there was no tax liability under previous law. These changes deem income to ac-

143 Dandekar, Taxation and Foreign Trade, Council For Economic Education, Taxation and Foreign Trade 58-67 (1957).
147 See 65 E. Economist 793-95 (1975).
148 H. Agrawal, supra note 72, at 119-20.
crue in India when in fact it accrues abroad. Under the law prior to 1976, royalty and technical fees were not taxable to nonresidents, if, in the case of a royalty payment, both the contract and actual payment were made outside India, and if, in the case of technical fees, the services relating to such fees were rendered wholly outside India. The legality of the new clauses is questionable because the Indian government cannot collect taxes if the nonresident's income has no nexus with India or if a transaction between a nonresident and an Indian lacks a sufficient territorial connection. One leading commentator observed:

Not only are these clauses contrary to the well-settled international norms of taxation on a foreigner in respect of his income accruing, arising and received outside the taxing state, but they are against the letter and the spirit of the various tax treaties entered into by India with foreign countries. Further, it is difficult to conceive of more powerful fiscal deterrents to keep away foreign collaborators.¹⁴⁹

The Direct Tax Laws Committee has recommended that clauses vi and vii of section 9(1) of the ITA be deleted and that the deeming of royalties and technical services fees as income in India be restored to the previous position.¹⁵⁰ At the same time collaboration arrangements are approved by the central government, a determination should be made by the central government of the amount of the fee that is deemed to accrue or arise in India and the amount of income (i.e., fees less expenses attributable thereto).¹⁵¹ The Indian government should consider seriously this recommendation. Resort to legal fiction to widen the tax net to tax nonresident companies adversely affects the attractiveness of foreign investment activities in India.

V. TAX INCENTIVES FOR FOREIGNERS

Acute competition among developing countries in attracting foreign capital has encouraged the enactment of investment incentives and has introduced a general liberalization of tax benefits offered by developing countries.¹⁵² However, the effectiveness of tax

¹⁵⁰ Recommendations of Direct Tax Laws Committee (1978), supra note 69, in ¶ 1:3.16.
¹⁵¹ The Chokshi Committees' Recommendations, supra note 69 are reprinted in H. Agrawal, supra note 72, at 651.
incentives in attracting foreign capital has been criticized\(^{153}\) and challenged.\(^{154}\) Tax incentives, it is urged, are only one of many factors that promote investments.\(^{155}\) As such, they assume only a marginal role in attracting capital to productive investment. Nevertheless, the widespread use of tax incentives by developing countries continues because of the belief that the absence of such incentives has an adverse effect on the flow of foreign investments.\(^{156}\) Although India is not unaware of the proper role of tax incentives in attracting foreign capital, it has shown only moderate enthusiasm for this method of stimulating investment activities. India's tax incentives are geared to a select group of industries and are designed to complement the overall planned development of the country.\(^{157}\)

Tax incentives for foreign technicians and tax concessions relating to the income of resident and nonresident companies have been discussed previously. This section discusses other investment and saving incentives, such as preferential tax treatment of industries in the rural sector and tax concessions for promoting the growth and expansion of specific industries.

A. Incentives for Investment and Savings

1. Depreciation Allowance

Depreciation is allowed on the basis of the recorded value of an asset or group of assets.\(^{158}\) The amount of the depreciation allowance is calculated by taking the percentage rate of depreciation for the asset against the original cost,\(^{159}\) and by deducting the appreciation allowed in previous years.

There are seven categories of annual depreciation rates.\(^{160}\)

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\(^{154}\) Y. Aharoni, The Foreign Investment Decision Process 241 (1966). The studies discussed by the author indicate that revenue costs significantly exceed benefits sought to be obtained through use of tax incentives.


\(^{156}\) Lent, Tax Incentives in Developing Countries, Readings on Taxation in Developing Countries 363 (R. Bird & O. Oldman eds. 1975).

\(^{157}\) H. Singhal, supra note 13, at 15.

\(^{158}\) I.T.A. § 32.

\(^{159}\) The word "cost" is not synonymous with "price." It includes all expenditures necessary to bring into existence and to keep the plant in working condition. Challapalli Sugar Ltd. v. C.I.T., [1975] 98 I.T.R. 167.

\(^{160}\) Income Tax Rules (1962), Rule 5.
Typical rates include: first class factory buildings, 5%; plants and machinery,¹⁸¹ 10% and 15%—usually the former (except for precision engineering, 30%); trucks, 30%; and office equipment, 10% and 15%. If more than one shift is worked, depreciation rates are increased by 50% (up to 100%) for every additional shift.¹⁸²

Writing-off the full cost in one year is permitted in the case of short-lived assets or assets whose cost do not exceed Rs 750 (about $100).¹⁸³ A depreciation allowance is available for capital expenditures incurred by a taxpayer on renovation, extension, or improvement of business premises, even if the premises are leased.¹⁸⁴ If the profits are not sufficient to absorb the allowable depreciation in a given year, the unused balance can be carried over to any successive year until fully absorbed against profits.¹⁸⁵

2. Investment Allowance

The Finance Act of 1976 provides a system of investment allowance,¹⁸⁶ in addition to normal depreciation allowances, which replaces the previous system of 20% initial depreciation allowance and development rebates for certain industries. Many companies are allowed to deduct 25% of the cost of new plants and machinery installed after March 31, 1976 from their taxable income for the year of installation. The investment allowance, combined with normal depreciation, can create a write-off exceeding 100%.

The investment allowance is subject to the condition that an amount equal to 75% is debited to the profit and loss account of the relevant previous year and credited to a reserve account to be called the "Investment Allowance Reserve Account." In the case of a ship, only 50% of the amount permitted as investment allowance is required to be transferred to the reserve account. The investment allowance reserve must be utilized by the taxpayer for the purposes of acquiring new ships, aircraft, machinery or plants within a period of ten years following the year in which the ship or aircraft was acquired or the machinery or plant was included.

¹⁸¹ For meaning of "plant," see J. Kanga & N. Palkhivala, supra note 35, at 375-76.
¹⁸³ I.T.A. § 32(1)(ii).
¹⁸⁴ Taxation Laws (Amendment) Act, 1970. Prior to amendment, such capital expenditure qualified for depreciation allowance only if the business premises were owned by the taxpayer.
¹⁸⁵ I.T.A. § 32(2).
¹⁸⁶ Id. § 32A.
stalled. During the interim, the investment allowance reserve may also be utilized for business expenses of the undertaking rather than for the distribution of dividends, for the remittance outside India of profits, or for the creation of any asset outside India. The investment allowance is withdrawn (and taxed) if the reserves created are not used for acquisition of new ships, aircraft, machinery, or plants during the ten-year period.  

In the 1977-78 budget, a 25% investment allowance was extended to all manufacturing firms except those producing beverages, cosmetics, cigarettes, and various other items of daily household consumption. At the same time, the investment allowance was raised to 35% for manufactured goods using local technology and products invented in India. These additional incentives are available only if the technology or product comes from an Indian government laboratory, the public sector, or a local university. The principles behind the investment allowance, such as carrying forward unabsorbed investment allowance, withdrawal of investment allowance in certain cases, or continuation of the allowance on amalgamation, are related to the scheme of development rebate.  

3. Amortization of Certain Expenditures

Section 35D of the ITA grants a deduction for expenditures that otherwise may be disallowed on the ground that they are of a capital nature or were incurred prior to establishment of the business. An Indian company may amortize preliminary expenses incurred in starting or extending a business. Preliminary expenditures for project or feasibility reports, market surveys, engineering services, company registration charges—up to a limit of 2.5% of the cost of the project, or the capital employed, may be amortized over a ten-year period from the commencement of a business.

To provide new incentives for the mining industry, eligible ex-
penditures\(^\text{174}\) incurred\(^\text{175}\) in operations relating to exploration and development of specified minerals after March 31, 1970, are entitled to amortization in ten equal installments over a ten-year period, beginning with the year in which the commercial production starts. This deduction is allowed against the profits from the commercial production of minerals, regardless of whether it was established as a result of operations for prospecting and development.

Capital expenditures for acquisition of patent rights or copyrights may be amortized over a period of fourteen years or over the unexpired life of the patent or copyright, whichever is less. The amounts are payable in equal installments.\(^\text{176}\)

4. **Partial Tax Holiday\(^\text{177}\)**

As part of India’s policy of accelerating the process of industrialization, profits of new eligible industrial undertakings are tax exempt for a period of five years up to 7.5% of the capital employed in the undertaking.\(^\text{178}\) If an undertaking does not make the requisite profits in the first five years, the deficiency can be satisfied up to eight years from the year of commencement of business.

Although the term “industrial undertaking” has been left undefined and the Central Board of Revenue has issued no illustrative list of eligible industrial undertakings, it is clear nonetheless that the major prerequisite for the tax holiday is that the industrial undertaking (unless it is a cold storage plant) manufacture or produce articles. The Indian company courts have construed this incentive liberally and in a broad commercial sense to encourage the establishment of new industrial enterprises.\(^\text{179}\) The capital employed in the undertaking is determined in accordance with Rule 19 and 19A of the Income Tax Rules of 1962. In-

\(^\text{174}\) I.T.A. § 35E(3). Expressly disqualified expenses are those entailed in acquiring the site or rights in the site, those entailed in acquiring the deposits or rights in or over such deposits, and expenses of assets eligible for depreciation allowance.

\(^\text{175}\) In order to be deductible, the expenditure must actually be incurred by the taxpayer and borne by the taxpayer within a five-year period preceding the date of commercial production. I.T.A. § 35E.

\(^\text{176}\) Id. § 35A.

\(^\text{177}\) For exhaustive discussions of this, one of the earliest tax incentives, see S. Ambiranjan, THE TAXATION OF CORPORATE INCOME IN INDIA 167-8 (1964); M. Kust, FOREIGN ENTERPRISE IN INDIA 386-88 (1964); H. Singhal, supra note 13, at 24-26.

\(^\text{178}\) I.T.A. § 80J.

sofar as Rule 19A excludes all borrowed capital (debentures and long-term loans) in computing the “capital employed” of an undertaking, leading commentators contend that the rule is *ultra vires.*

5. **Capital Expenditures for Scientific Research**

Capital expenditure on scientific research, which previously could be amortized over a period of five years, is now allowed in full as a deduction during the year in which the expenditure is incurred, provided it relates to the taxpayer’s business or is paid to an approved university or institution. Capital expenditures for scientific research incurred during the three years immediately preceding the commencement of a business may also be written-off against the profit of the year in which the business is commenced. If the expenditure cannot be absorbed by the profits of a particular year, the balance can be carried over indefinitely.

B. **Incentives to Specific Industries: Hotel, Shipping, Tea, Mineral Oil, and Agriculture**

India gives favorable treatment to the hotel industry because it is considered as a potential source of foreign exchange. During the first five years of operation of a new hotel, 7.5% of the capital employed is exempted from income tax. If a new hotel does not make sufficient profits in the first five years, the period may be extended up to eight years. The incentive applies only to hotels owned by companies and approved by the central government.

Other important incentives for the hotel industry include:

1. An extra depreciation allowance 50% greater than the normal depreciation allowance on machinery and plants.
2. A deduction of 20% in computing taxable profits if the hotel is located in specified remote areas.
3. An investment allowance of 25% for new hotels owned by Indian companies and completed after March 31, 1967.

Five hotels constructed as joint ventures (four with the United

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180 J. KANGA & N. PALKHIVALA, supra note 35, at 678.
181 I.T.A. § 35.
182 Id. § 35(4).
183 Id. § 32(1)(v).
185 I.T.A. § 32A.
States and one with the United Kingdom) are already in operation and four others are in progress.\textsuperscript{186}

Similar incentives are offered to the ship and aircraft industries. Among the incentives are:

\begin{enumerate}
\item A $7.5\%$ exemption of capital employed in shipbuilding by an Indian company; and
\item An investment allowance of $25\%$ for new ships or aircraft acquired after March 31, 1976.
\end{enumerate}

The production and sale of tea is both a business transaction and an agricultural operation. Income derived from the sale of tea grown and processed by the seller in India is computed as if it were derived from business, with $40\%$ of such income charged to Indian income tax.\textsuperscript{187} An allowance is given for the replacement of dead or permanently useless bushes.\textsuperscript{186} A development allowance is permitted for taxpayers who grow and process tea and for expenditures incurred in planting tea bushes. An allowance of $50\%$ of the cost of planting tea bushes on land not previously planted and of $30\%$ of the cost of planting replacement bushes also is available.\textsuperscript{189} Subsidies received from the Tea Board for replanting or replacement of tea bushes are not included in total income.\textsuperscript{190}

Mining also is encouraged. The following allowances, if specified in the agreement between the government and the taxpayer, may be deducted from profits of any business involved in prospecting, extracting, or producing mineral oils, in lieu of or in addition to the deduction allowable under the Act:

\begin{enumerate}
\item abortive exploration expenses;
\item exploration and drilling expenditure after commencement of commercial production; and
\item value of depletion of mineral oil in the mining area.\textsuperscript{191}
\end{enumerate}

A deduction of one and one-fifth times the expenditure incurred is allowed Indian companies engaged in other specified undertakings, including manufacturing or processing the products of agriculture, animal husbandry, or dairy farming.\textsuperscript{192}

\begin{footnotes}
\item\textsuperscript{186} \textit{Indian Investment Centre, Joint Ventures Abroad} 75 (1976).
\item\textsuperscript{187} Income Tax Rules (1962), Rule 7.
\item\textsuperscript{188} Income Tax Rules (1962), Rule 8.
\item\textsuperscript{189} I.T.A. §§ 33A & 155A.
\item\textsuperscript{190} Id. § 10(30).
\item\textsuperscript{191} Id. § 42.
\item\textsuperscript{192} Id. § 35(c).
\end{footnotes}
C. *Export Promotion*

To improve the balance of payments situation through increasing foreign exchange earnings, a weighted deduction of a sum equal to one and one-half times (one and one-third of expenditure incurred after March 31, 1978) the amount of any expenditure incurred on any marketing efforts outside India for the development of export markets is allowed to a domestic company or to any other person resident in India. Although there has been a substantial increase in India's exports, this incentive is inadequate. The government should consider supplementing the existing incentive with a tax rebate similar to the system used prior to 1966.

D. *Incentive for Industries in Backward Areas*

India has focused attention on removing imbalances in the economy by fostering industrial growth in less developed areas. The central government offers a subsidy of up to 15% of the fixed capital investment with a maximum of Rs 150,000. A deduction of 20% of the profits is allowed in computation of taxable income for the ten-year period after the establishment of an industry in backward areas. Subject to approval by the Central Board of Direct Taxes, tax credit is given for expenses of relocating an industry from an urban center to a more remote area. Other incentives are provided for shifting industries to backward areas. For example, financial institutions provide concessional finance for locating industries in underdeveloped areas. Various state governments provide infrastructure, such as developed land, transport, power, water, and industrial housing at subsidized costs for industries willing to relocate in remote areas.

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193 *Id.* § 35B.
194 The government of India introduced the Tax Credit Certificate (export) Scheme in 1965, under which the amount shown on a tax credit certificate granted to any person was adjustable against any existing liability of that person under the I.T.A. The application of the Scheme, however, did not extend to exports made after 5 June 1966. Also, prior to 1966 the tax rebate of an amount equal to the income tax (calculated at one-tenth of the average rate of income tax on the amount of such profits and gains derived from the export of any goods or merchandise out of India) was granted. This is an amount equal to the income tax calculated at the average rate of income tax on an account equal to two percent of the sale proceeds receivable in respect of manufacture as well as export of articles specified in the first schedule of the Industries (Development and Regulation) Act, 1951.
195 I.T.A. § 80HH.
196 *Id.* § 280(2)(A).
197 65 E. Economist 796 (1975).
E. Summary

Tax incentives offered by India seek to encourage both investment in new industries and reinvestment of capital in existing industries. Although partial tax holidays are one incentive for new investment, depreciation and investment allowances are designed specifically to encourage reinvestment. The law is not clear as to whether a business that has enjoyed a tax holiday can enjoy an additional tax holiday in connection with a contemplated reinvestment. It appears that an important factor is whether the earnings are to be reinvested in the same business or in a new business. If a new business is involved that qualifies for special tax incentive in its own right (for example, a priority industry), then tax incentives arguably should be available. The fact that funds are coming from earnings generated by a business that has itself enjoyed tax exemption should not matter. The character of the new business should be the crucial factor. On the other hand, if the new business does not qualify for special tax incentives, reinvested earnings as the source of funds arguably should not make a difference. When the earnings of a business that has qualified for a tax exemption are to be reinvested in the same business, then, if the industry has not developed completely or if further encouragement of expansion appears desirable, a case can be made for extending the concessions to the reinvested earnings. The Indian government, consistent with its industrial policies and objectives, should consider granting a tax holiday on the expansion of an enterprise through reinvestment.

The investment allowance, by reducing the cost of acquisition of new productive facilities, makes more funds available for reinvestment and distribution. An investment allowance does not merely defer tax liability but eliminates it altogether. Accelerated depreciation permits rapid write-off of the cost of acquisition of capital equipment. It differs from an investment allowance principally in that it defers rather than eliminates taxation. The more depreciation taken in early years, the less there will be available in the latter part of the useful life of an asset.

It should be noted that the lure of tax incentives alone does not attract foreign investment. In addition to the tax incentive, the Indian government should assist the foreign investor by providing plant sites, low-priced electricity or other resources or manpower training programs to adapt the labor supply to the manpower needs of the investor. The government may also assist in establishing markets for products. All of these factors increase
profitability, often as directly as tax measures. Although the tax
factor is only one of several considerations affecting the flow of
foreign capital, the successful operation of tax incentive programs
offered by the Indian government reflects a favorable overall in-
vestment climate.

VI. UNITED STATES TAX LAWS AND FOREIGN
INVESTMENTS IN INDIA

For successful tax planning of foreign investments in India and
for calculating the total tax liability, a United States investor
should consider not only the Indian tax laws and tax incentives,
but also the treatment of income earned from such investments
under domestic law. United States tax laws recognize the primacy
of the claim of the country of source (i.e., India) to taxable
income,198 and provides certain unilateral measures to eliminate
double taxation, such as tax deferrals,199 and foreign tax credit.200

The foreign subsidiary of a United States parent corporation
generally is not subject to U.S. income tax on its foreign source in-
come. However, the foreign source income is subject to tax when
distributed as dividends to shareholders over whom the U.S. as-
serts worldwide jurisdiction. The effect of this combination of
rules usually is referred to as “deferral.”201 Thus, the U.S. tax on
foreign source income earned by a foreign corporation is deferred
or postponed until the corporation pays dividends to U.S. share-
holders. If the payment of the dividend is connected with the con-
duct of a trade or business within the United States, taxation is, of
course, not deferable.202 The foreign income, however, remains
subject to applicable foreign taxes. When these foreign taxes ap-
roach or exceed the U.S. tax that would have been imposed had
the foreign income been currently taxable by the United States,

198 I.R.C. §§ 861-864. The exclusive function of these rules is to establish whether income
is derived from sources within the United States (U.S. Source Income) or from sources
without the United States (foreign source income). Other sections of the Code spell out the
operative results that flow from the source determination. B. JUST, FOREIGN OPERATIONS—
SOURCE OF INCOME, 80-4th Tax Management.
199 U.N. DEPARTMENT OF ECONOMIC AND SOCIAL AFFAIRS, UNITED STATES OF AMERICA: IN-
ST/ESA/39. [Hereinafter cited as UNESA].
200 I.R.C. §§ 901-907.
201 UNESA, supra note 199, at 28.
the advantage of deferral is diminished.\textsuperscript{203} The tax "deferral" scheme under United States law has worked in India's favor because it encourages the subsidiary corporation to reinvest profits in India. This is consistent with India's desire for long-term investment and reinvestment of earnings and helps to discourage short-term in-and-out types of investments.\textsuperscript{204}

Foreign taxes of all types, except gift and estate taxes, are deductible from gross income by United States corporations, citizens, and residents in computing taxable income. In addition, certain foreign taxes may be credited directly against the United States income tax liability of these taxpayers. Only foreign income taxes (foreign taxes imposed in lieu of income taxes paid by ten percent owned foreign subsidiaries of U.S. corporations) may be credited.\textsuperscript{205} The direct credit against United States income tax is designed to relieve international double taxation of foreign source income and to minimize the differences in tax treatment between domestic and foreign investments. The effect of the credit is that taxpayers subject to U.S. worldwide tax jurisdiction are relieved of U.S. tax on their foreign source income only to the extent that it has already borne foreign income taxes.\textsuperscript{206} Foreign income taxes that are equal to or greater than the applicable U.S. tax on foreign source income cancel U.S. tax liability on that income. Thus, the credit allows U.S. investors to pay only the higher of the U.S. and the foreign tax with respect to their foreign source income. For example, if the rates of income tax in India and the United States are 70\% and 48\%, respectively, the U.S. investor's total liability would be 70\% and no liability under U.S. law would arise. However, if due to various tax benefits the effective Indian tax is reduced to 30\%, then the U.S. investor will pay tax at a rate of 48\% (30\% to India and 18\% to the U.S.). Thus, it is clear that the effect of the grant of a tax concession by India is merely to reduce the taxes paid to India and to increase the taxes paid to the U.S.\textsuperscript{207}

\textsuperscript{203} Recent tax proposals would phase out deferral over a three-year period but allow Congress to continue deferral by treaty for certain types of income. See President Carter's Tax Proposals, [1978] 7 Fed. Taxes (P-H).

\textsuperscript{204} H. Singhal, supra note 13, at 44.


\textsuperscript{206} The excellent work on the subject is E. Owens, The Foreign Tax Credit (1961). See also Surrey, The U.S. Taxation of Foreign Income, 1 J. L. & Econ. 72 (1958).

Another problem that arises due to the divergence in the source rules under the U.S. and Indian income tax laws is that of obtaining credit for foreign taxes paid. Under the U.S. income tax law, the source of income of transactional sales is determined by the place of passage of title. If a U.S. seller accepts an order, passes title, and receives payment in the United States, no income will arise or be received in India. Such income will be taxed under the U.S. law but not under the Indian law. Where, however, the sale is affected through an Indian distributor or branch office, a portion of the profits from the sales will be deemed to arise in India under the “business connection” theory. This portion of the profit would be taxed under the Indian law. Because passage of title took place in the U.S., the source of income would be in the U.S. and the profits would be taxed under U.S. law. No credit for the Indian taxes paid would be available to the U.S. seller. On the other hand, if the passage of title also takes place in India, the entire profit would be taxed only in India and payment of such taxes would be credited under U.S. foreign tax credit laws.

For example, consider the following situation. If profits are allocated on an equal basis between the U.S. and Indian offices, the tax liability on a profit of $100 would be as follows:

- Indian income tax at 70% \( \times \) $50 = $35.00
- U.S. income tax at 48% on $65 (i.e., after deducting $35) \( \times \) 48% = $31.20
- Total tax liability \( \times \) $35 + $31.20 = $66.20

If the entire profit of $100 was subjected to Indian income tax, the total liability would be \( \times \) $100 \ times 70\% = $70.00

There is no divergence in source rules between U.S. and Indian tax laws with respect to royalties and technical fees. Royalties are

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208 The limitations application to the foreign tax credit, which are fixed by the amounts of the taxpayer’s foreign source income, are determined under United States source rules. I.R.C. §§ 861-862; G.C.M. 86-4 25131, 1947-2 C.B. 85; Exolon Company v. Commissioner, 45 B.T.A. 844 (1941); Ronrico Corporation v. Commissioner, 44 B.T.A. 1130 (1941); Commissioner v. East Coast Oil Co., S.A. 85 F.2d 322 (5th Cir. 1937). But see United States v. Balanovsky, 131 F. Supp. 898 (S.D.N.Y. 1955).

209 Refer to Part IV supra.


212 Rule 10, Income Tax Rules (1962), empowers the income tax officer (ITO) to make allocation of a portion of profits arising in India, determined on the basis of the facts of each transaction.
held to arise in India. Technical fees accrue and arise in the country where the services are rendered. In most cases, they arise both in India and in the United States. Similarly, dividends and interest paid to a U.S. subsidiary in India constitute foreign source income of the U.S. parent company. The 25% Indian tax on dividends paid by a U.S. subsidiary may be creditable to the U.S. parent corporation under the foreign tax credit. Because the Indian tax rates on interest and on capital gains, which are 70% and 40% respectively, are higher than the normal effective U.S. rate of 25% on interest and on capital gains, an American company will be able to absorb only partially, that is up to 25%, the Indian tax under foreign tax credit. However, resort to "over-all limitation" may prove helpful in absorbing the entire Indian tax.

From the foregoing discussion, it is clear that the U.S. foreign tax credit, by not recognizing the tax incentives given by India, does not help to promote the flow of private foreign investments from the U.S. to India. Whether the United States should adjust its system to make effective such foreign tax incentives has been debated for many years. President Eisenhower endorsed the principle of recognizing tax incentives granted by developing countries. In his Economic Report to Congress in January 1957, he stated:

At present, foreign tax inducements to attract capital are in some situations nullified by not allowing credit in determining United States tax liability for income taxes waived by the country in which the investment is made. The investment of private funds abroad would be facilitated by tax treaties which, subject to appropriate safeguards, recognize the laws of other countries designed to attract new investment.

One effort to give expression to this principle was made in the U.S.-India tax treaty of 1959. Article XII provided for a "tax

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214 I.R.C. § 862(a)(2), (5)-(6).
216 Under overall limitation on the foreign tax credit, a U.S. corporation can average foreign income taxes paid in different countries and thereby can absorb the high taxes of one country by averaging with the low taxes in another country. Recent legislation has eliminated the per-country limitation on the foreign tax credit. See IRC § 904(c).
217 J. HELLER & K. KAUFFMAN, supra note 207, at 68-78.
219 Similar tax treaties were negotiated by the United States with Israel and United Arab Republic but neither has been ratified. See BIJAWAT, supra note 218, at 292.
sparing” scheme,\textsuperscript{220} which allowed a foreign tax credit for taxes normally due to India but forgiven by India under its tax incentive program.\textsuperscript{221} The treaty was never ratified, partially due to the United States Senate’s indecision as to the “tax sparing” provision.\textsuperscript{222}

Failure to incorporate the tax sparing scheme in the tax treaty has made it quite unprofitable for the U.S. investor to enter the markets of India for raw material and labor. Investors who do enter the market may be forced to do business at a competitive disadvantage, in view of the fact that the investment carries the full burden of American taxes while competitors from other developed countries enjoy all the benefits of low taxes in India.

India has agreements for avoidance of double taxation with Japan and West Germany based on the method of tax credit; \textit{i.e.}, the tax in the two countries is levied according to their respective laws but credit for the tax payable in one country is provided for by the other in respect to income from sources allocated to the first country. These agreements provide for credit for tax that \textit{would} have been paid in India without certain tax incentives.\textsuperscript{223}

The need for a review of U.S. tax policy vis-a-vis investments in India is apparent. To stimulate investment, the U.S. should consider a direct grant program that would incorporate interest-free loans to investors in India, with safeguards provided under tax laws. To continue the benefit of deferral, the provision should be made to continue deferral on income from active investments. The U.S. investors also should be granted special depreciation deductions, reinvestment allowances, and tax free reserves with respect to qualifying investments in India.

\section*{VII. Conclusion}

Foreign investors, generally speaking, are rational and pragmatic businesspeople, whose primary objective is maximization of profits from their investments. Taxation of investment in India will not discourage foreign investors if taxes can be absorbed at no additional cost and if foreign investors appreciate the reasonableness and long-term benefits of the Indian taxation

\begin{footnotesize}
\begin{itemize}
\item[\textsuperscript{220}] M. \textsc{Kust}, \textit{Tax Treaties with the Under-Industrialized Countries}, 13 \textsc{Tax Executive} 179-80.
\item[\textsuperscript{221}] U.N. \textsc{Department of Economic and Social Affairs, Tax Treaties Between Developed and Developing Countries} (U.N. Doc. E/4614/ST/ECA/110 (1969)).
\item[\textsuperscript{222}] For pros and cons of tax sparing, see \textsc{Bijawat, supra} note 218, at 244-52.
\item[\textsuperscript{223}] For the text of the tax treaties, see H. \textsc{Agrawal, supra} note 72, at 483-536.
\end{itemize}
\end{footnotesize}
system. The taxation of foreign investment in India is indeed elaborate and complex. However, it should be noted that tax receipts account for less than 15% of national revenues. High rates of personal and corporate taxation are due to a narrow tax base. For example, no central taxes are levied upon agricultural income, and a widening of the tax base would necessitate taxation on agricultural income—a remote possibility. The heavy burden of personal taxation is reduced to a great extent by the exemptions granted foreign technicians.\(^{224}\)

Although the corporate tax rate is 55% of net profits, and profits above certain levels are subject to a 25% surtax, it can be shown that the effective rate of these taxes for the first five years of operation of a new company is likely to be around 35%, when investment allowance, priority industry deduction, tax-holiday benefits, and tax credits are taken into account. When the impact of the withholding tax on inter-corporate dividends is taken into account, the effective rate in this period, so far as the foreign corporate investor is concerned, would be 36-37%.\(^{225}\) For international comparisons, the relative depreciation allowances, the amortization provisions, and the liberal allowable expense should all be considered. In comparing results in equity investments, one should note that loan funds have lower rates of interest, especially if a substantial part of the long-term loan is obtained from institutional sources at concessional rates, as is the case with major new projects in priority fields. The advantages continue well beyond the five to eight-year period for establishment of industries.\(^{226}\)

Tax incentives have been assigned an important role in India's policy toward foreign investments. The allegation that India's tax incentives are enacted on an ad hoc basis and cause uncertainty among investors as to their continued availability overlooks an important feature of India's tax policy. As suggested in the introduction to this paper, "the Indian tax system is an integral part of an overall development strategy; as that strategy and the priorities inherent therein change, so must the tax system."\(^{227}\) However, all tax incentives owe their existence to a permanent statute, the Income Tax Act of 1961, and their continued availability is not dependent upon the exercise of administrative discretion or

\(^{224}\) For detailed discussion of personal taxation, see part III supra.

\(^{225}\) M. Kust, supra note 129, at B-63.

\(^{226}\) See Mozoomdar, Overseas Investment and Indian Taxation, Private Foreign Investment of the Developing World, 141, 151-59 (1971).

\(^{227}\) H. Singhal, supra note 13, at 44.
political pressure. Thus, the need for negotiation and possibility for discrimination in favor of domestic companies is minimized.

However, the role of tax incentives in attracting foreign investment should not be overstated. The general investment climate and opportunities for profitable investment in developing countries are vastly more important than any tax advantages. It is worth examining, however, which of the tax incentives have any practical effect on entrepreneurial decisions, and which only add to the administrative burdens of tax collection while sacrificing revenue.

United States investors generally have found India's investment climate favorable. The U.S. currently accounts for almost 30% of outstanding private foreign investment in India, with an estimated investment of about $358 million. Investments pioneered by U.S. companies have acted as development catalysts in several key industrial areas, notably petroleum refining, fertilizers, fine chemicals, pharmaceuticals, synthetic rubber, electronics, shrimp trawling, hotels, and other fields.

The strict application of the Foreign Exchange Regulation Act (FERA) caused considerable alarm in the minds of U.S. investors. Under FERA, foreign companies, except for a few "special cases," were asked to reduce their Indian holdings to less than 40%. However, the Foreign Exchange Regulation Act was not intended to discourage foreign investment, as is evident from the fact that the Indian government allowed investments pursuant to FERA to expand into many areas. Instead of lowering their investments, many companies reduced their shareholdings by expanding into new business sectors with Indian participation. The government preferred such diversification to the loss of foreign exchange, which would have occurred if the companies had departed.

In the wake of Indira Gandhi's return to power, it is suggested that a more open-minded attitude toward foreign investment will emerge. There is, however, little prospect of any major weakening of FERA, although liberalization of its ground rules is possible. For example, it is reported in the Indian press that foreign com-

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228 Recent figures show that American firms in India enjoy profits of 14.7%, compared to 12% in Europe, 10.7% in Latin America, and 8.6% in Canada. See H. Singhal, supra note 13, at 3.


Companies may be allowed to drill for oil in India. Although foreign investment does not rank among the top priorities of the present government, it is an area that, if liberalized, could help to stimulate and to open up the economy. Finally, a United States investor's remark might be worth remembering:

anybody who invests in India is a sucker, but anybody who does not invest in India is a bigger sucker.\(^{22}\)

*Udai Vikram Singh*

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\(^{221}\) See *Financial Times Survey* 8 (March 17, 1980).
