

Basic principles of international taxation economics essay



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Rapid economic development happens to be one of the primary objectives of all developing economies and India is not an exception. This is possible mainly through the accumulation and proper use of capital. The developing economies lack adequate basic infrastructural facilities. In order to develop these, the government takes upon itself the responsibility for building up capital formation, through sound taxation policies.

India is a mixed economy. Liberalization, privatization and globalization have further strengthened the role of tax policy in economic development. Both the public and the private sectors have to play an important role in ensuring satisfactory growth rate. For this, the government has to work out and provide adequate avenues for raising funds by private enterprises. This envisages the need to provide adequate incentives, rebates and reliefs in the form of tax deductions etc to stimulate the private sector. Here again a sound tax policy and a robust tax structure is inevitable. In order to accomplish the above objectives, the government enacted the Income Tax Act, 1961 repealing the act of 1922.

The present Act has realized due weight age of taxation of International Business which has assumed much importance to the tax collector as well as to the tax payers.

1. 2 INDIAN TAX STRUCTURE

The Indian direct tax policy is structured in such a way as to ensure high progressivity both in terms of tax on income as well as on wealth. The act ensures that higher the level of income, higher shall be the tax incidence.

By virtue of entry 82 of List I of the seventh schedule of the constitution of India, the Parliament is empowered to levy tax on income other than agricultural income. Therefore with due exercise of this power the Parliament has enacted the Income-Tax Act 1961.

It is a comprehensive act embodied with 298 sections, divided in XXIII chapters, fourteen schedules, along with yearly Finance Acts coupled with Income Tax Rules, 1962.

1. 3 BASIC PRINCIPLES OF INTERNATIONAL TAXATION

There are two basic principle followed by different countries in International taxation

1) Residence Based Taxation- The principle of residence-based taxation asserts that natural persons or individuals are taxable in the country or tax jurisdiction in which they establish their residence or domicile, regardless of the source of income. In the case of non-natural persons such as companies or firms, the place of incorporation or the place where control or management is exercised is deemed to be the place of residence. In the context of income tax, the ability to pay the tax in a country is fully measured by their global income. Therefore, the principle of residence-based taxation of income envisages the taxation of global income. Accordingly, India follows residence based taxation in case of Residents.

2) Source Based Taxation- There are individuals/entities whose “ residence” is in one country but their business is actually carried on in another country and their income is earned in the latter country. In such cases, the principle

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of residence-based taxation would be inappropriate. Therefore, there is a view that the country which provides the opportunity and facilities to generate income or profits should also have the right to tax the same. This forms the underlying basis of the principle of source-based taxation of income. India follows source based taxation in case of non-resident.

1. 4 INTERNATIONAL BUSINESS; CONCEPT, SCOPE AND STRUCTURE

International Business is a term used to collectively describe all commercial transactions (private and government, sales, investments, logistics and transportation) that take place between two or more regions, countries and nation beyond their political boundary. Usually private companies undertake such transaction for profit, government undertake them for profit and political reasons. In other words, it refers to all those business activities that involve cross border transactions of goods, services, resources between two or more nations. Transactions of economic resources include capital skills, people etc for international production of physical goods and services such as finance, banking, insurance, construction etc.

International Business does not only refer to multinational companies striking deals with foreign organization and making headways into the foreign market. It also involves small and independent companies or businessmen engaging in business with international clients through the convenient medium of internet.

International Business comprises a large and growing portion of the world's total business. Today, almost all companies-large or small-are affected by

global events and competition because most sell output and/or secure supplies from foreign countries or compete against products and services that come from abroad.

While operating internationally, a company would always consider its:

MISSION i. e. what the company will seek to do and become over the long term.

OBJECTIVES i. e. specific performance targets to fulfil its mission.

STRATEGY i. e. the means to fulfil its objectives.

International Business has been growing recently at a faster pace due to the following factors.

Rapid increase in and expansion of technology

Liberalization of government policies regarding cross-border movement of trade and resources

Development of the institutions needed to support and facilitate international trade

Increased global competition

In today's scenario, the scope of International Business has widened. It may take any mode i. e.

Importing and exporting (goods and services)

Tourism and transportation

Licensing and franchising

Turnkey operations

Management contracts

Direct and portfolio investment

And much more

MERCHANDISE EXPORTS are tangible goods sent out of a country.

MERCHANDISE IMPORTS are tangible goods brought in. As these goods can be seen to leave and enter, they sometimes are referred to as visible exports and imports. This is country's key international economic transaction.

SERVICES are earning other than those derived from goods. Earning received are service exports and earnings paid are service imports.

INTERNATIONAL TOURISM and TRANSPORTATION are important sources of revenue for airlines, shipping companies, travel agencies, and hotel. Greece and Norway is earning a significant amount of employment, profit and foreign exchange from foreign cargo that is carried on ship owned by citizens of that country. Bahamian economy is also dependent more on earning from foreign tourism than earning from the export of merchandise. U. S. has in recent years earned more from foreign tourism than from its exports of agricultural goods.

On an international level, fees are paid for engineering services that often are handled through TURNKEY OPERATIONS-construction, performed under contract of facilities that are transferred to the owner when they are ready to begin operating. Fee also are paid for management services that often result from management contract-arrangement whereby one company provides personnel to perform general or specialized management functions for another company.

The use of assets such as trade-marks, patents, copyrights or expertise under contracts also known as LICENSING AGREEMENT generates earnings called royalties. FRANCHISING is a way of doing business in which one party (the franchisor) allows another party (the franchisee) the use of trademark that is an essential asset for the franchisee's business. The franchisor also assists on a continuing basis in the operation of business such as by providing components, management services and technology.

Foreign investment involves ownership of foreign property in exchange for financial return. A DIRECT INVESTMENT is one that gives the investor a controlling interest in a foreign company, such as a direct investment is called foreign direct investment (FDI).

A PORTFOLIO INVESTMENT is an investment that gives the investor a non-controlling interest in a company or ownership of a loan to another party.

CONTRACT MANUFACTURING - it refers to a type of International Business where a firm enters into a contract with one or few local manufacturers in foreign countries to get certain components or goods produced as per its

specification. It is also known as OUTSOURCING. It can take three major forms;

Production of certain components such as automobile component or shoe uppers to be used later for producing final products such as cars and shoes.

Assembly of components into final product such as assembly of hard disc, mother board, floppy disc drive etc.

Complete manufacture of the product such as garments.

The major international companies such as NIKE, REEBOK, LEVIS, today get their products or components produced in the developing countries under contract manufacturing.

1.5 NEED FOR INTERNATIONAL BUSINESS

International Business helps both the countries to earn foreign exchange which it can later use for meeting its imports of capital goods, technology, petroleum products and fertilizers and a host of consumer product and services at affordable price.

International Business operates on a simple principle -produce what your country can produce more efficiently, and trade the surplus production so generated with other countries to produce what they can produce more efficiently. If such an exchange pool of goods and services is distributed equitably amongst nations, it benefits all the trading nations.

Producing solely for the purposes of domestic consumption severely restricts a country's prospects for growth and employment. International Business

helps developing countries to execute their plan to produce on a larger scale and thus create employment for people as well.

In the absence of international trade of goods and services, it would not have been possible for the world community to consume goods and services produced in other countries that the people in these countries are able to consume and enjoy a higher standard of living. Business firms find frustrating when demand for their products starts getting saturated in the domestic market. Such firms can considerably improve prospects of their growth by plunging into overseas markets. This is precisely what has prompted many of the Multinational from the developed countries to enter into markets of developing countries.

International Business can be more profitable than the domestic business. When the domestic prices are lower, business firms can earn more profits by selling their products in countries where prices are higher.

Many firms set up production capacities for their products which are in excess of demand in the domestic market. By planning overseas expansion and procuring orders from foreign customers, they can use their surplus production capacities and also improve the profitability of their operation. Production on a larger scale often leads to economies of scale, which in turn lowers production cost.

1. 6 REVIEW OF EXISTING STUDIES

No study seems to have been made in India to cover the various aspects of Taxation of International Business. This section presents a brief review of

some of the important studies conducted on the subject of taxation. These studies would provide background material for the proposed work.

Goenka (1983)¹ emphasized the need for evolving an optimum direct tax planning process for our business entities, which will enable them to maximize their after-tax profits, so that these are available for establishing new industries and expanding the existing ones. Tax planning has emerged as an important tool for management decisions beginning with the settling up of an enterprise to the level of strategic, project and operational planning constituted at different stages of development of an enterprise and at different levels of policy formulation and operation. Tax planning would in no way lead to tax loss to the national exchequer; as the corporate sector progresses at a faster pace, Government can not only recoup the tax loss but improve upon the same.

Agarwal (1987)² has emphasized on tax incentives as an instrument of Fiscal policy to achieve the stated objectives of mobilizing saving and inducing investment. In the opinion of author, tax incentives offer a relatively straight forward means of promoting industrialization compared to other long term or complex measures that are more difficult to implement.

However, tax incentive may not be used and may not yield the desired results. So tax incentives may be complemented with some of the other alternative measures to achieve the desired results.

The study also revealed that the type, size and magnitude of tax incentives offered in different countries vary very widely depending upon the needs and aspirations of their people. So incentive programme in India has undergone a

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number of changes from time to time and has a wide coverage. India is offering largest number of tax incentives as a part of its tax incentives package.

Agarwal (1991)³ observed that significance of personal income tax can be judged in terms of its share in total tax revenue or national income. The contribution of direct taxes in general and of personal income tax in particular to the total tax receipts of Union Government of India has declined over time. India has depended more on indirect taxes for additional resource mobilization. Frequent upward revision of the exemption limit under the personal income tax tends to restrict growth of the tax base. The study covers the single major category of personal income tax payers - individual. These account for more than 90% of the total number of personal income tax payers and their taxable income.

The observed elasticity, progressivity and re-distribution impact of a tax is the net effect of interaction between tax parameters (such as tax schedule) and non tax parameters (such as income inequality). The study has concentrated on observed empirical functions and not on behavioural relations. So the discussion of tax evasion and tax compliance is beyond the scope of the study.

Jain (1991)⁴, revealed that the private corporate sector has been looked upon as an important source of saving in India. The Government has succeeded in influencing the corporate decision processes at different levels and encourages them to save more.

In Indian tax structure, there is a heavy tax on company's profits which reduces savings since it is assumed to be borne by the companies themselves; so the question of mechanics of corporate saving behaviour was probed into and she identified the possible channels through which taxes could influence corporate saving decisions.

She insisted on revamping the tax structure. A reduction in tax rate would have a favourable impact on retention, resulting in utilization of more internal finance and ploughing back of profits.

Tax reductions have to be combined with a corresponding review and reduction of tax incentives and fiscal incentives provided to the corporate sector.

KADEL (2000)⁵ stated that Nepal, a small under developed country of the world economy, started using tax incentives to encourage private investments. The result was the introduction of tax holiday system and providing many other tax related facilities by Industrial Enterprise Act in 1962 and motive was to attract private investment. Since then, series of changes in tax rules were noticed. One of the objectives of all these changes was to create investor friendly environment and in turn increase investment. The author revealed that inflation is the main source of distortion for the corporate tax system in Nepal. Inflation rate and effective tax burden in Nepal are negatively related. The main determinant of fixed asset investment in Nepal is the availability of market or customer. The tax factor too as a determinant of fixed asset investment is playing only a small role in this regard. Across the four techniques of providing tax incentives i. e., tax

holiday, accelerated depreciation, investment allowance and tax rate reduction, investment allowance is the best method to reduce the effective tax burden. Full tax holiday system is not preferable for both the reduction of tax burden and getting equity in the tax system.

The proposed study will attempt to bridge the gap by focusing on international business.

1. 7 STATEMENT OF THE PROBLEM

India, the world's largest democracy, has emerged as a strong player on the international arena. For many years India's role in international affairs is increasing at a higher pace. The aim for major changes initiated by the Indian Government is to sweep away much burdensome regulation and create a business friendly environment for domestic and international business. Development took place through many reforms e. g. macro-economics reforms, tax reforms, finance reforms and freeing of capital markets, reforms in the regulation of business firms, revitalization of the Indian private sector, removal of exchange control and convertibility, trade reforms and foreign direct investment, reduction in licensing and quota raj as well as inspector's domain.

Tax reforms, initiated in 1991, have sought to rationalize the tax structure and increase compliance by taking steps in the following directions:

Reducing the rates of individual and corporate income taxes, excises, and customs and making it more progressive.

Simplification of laws and procedures and introduction of Advance Ruling

Introducing tax incentives in the form of exemptions and concessions.

Easing out the rules relating to filing of returns (E-filing), TDS

Laws relating to IB have also been simplified.

Despite the above steps initiated by the government, the problem of ambiguity is continuing viz.

(1) Business entities are not sure of their future tax liability in terms of rate of tax (to be applied in years to come, changing by virtue of Finance Act)

(2) Retrospective amendment in the law has its own impact on foreign business entities.(Vodafone International Holding BV v Union of India)

Vodafone was embroiled in a \$2.5 billion tax dispute with the Indian Income Tax Department over its purchase of Hutchison Essar Telecom services in April 2007. It was being alleged by the Indian Tax authorities that the transaction involved purchase of assets of an Indian Company, and therefore the transaction or part thereof was liable to be taxed in India.

Vodafone Group Plc. entered India in 2007 through a subsidiary based in the Netherlands, which acquired Hutchison Telecommunications International Ltd's (HTIL) stake in Hutchison Essar Ltd (HEL)-the joint venture that held and operated telecom licences in India. This Cayman Islands transaction, along with several related agreements, gave Vodafone control over 67% of HEL and extinguished Hong Kong-based Hutchison's rights of control in India, a deal that cost the world's largest telco \$11.2 billion at the time.

The crux of the dispute had been whether or not the Indian Income Tax Department has jurisdiction over the transaction. Vodafone had maintained from the outset that it is not liable to pay tax in India; and even if tax were somehow payable, then it should be Hutchison to bear the tax liability.

In January 2012, the Indian Supreme Court passed the judgement in favor of Vodafone, saying that the Indian Income tax department had “ no jurisdiction” to levy tax on overseas transaction between companies incorporated outside India. However, Indian government thinks otherwise. It believes that if an Indian company, Hutchison India Ltd., conducts a financial transaction, government should get its tax out of it. Therefore, in 2012, India changed its Income Tax Act retrospectively and made sure that any company, in similar circumstances, is not able to avoid tax by operating out of tax-havens like Cayman Islands or Lichtenstein. In May 2012, Indian authorities confirmed that they were going to charge Vodafone about Rs. 20000 crore (US \$4. 5 billion) in tax and fines. The second phase of the dispute is about to start.

3.) Lots of disputes and litigation is pending before the various court of law of the country which are deciding factors for tax liability of business entities.(Idea Cellular-AT&T, GE-Genpact, Mitsui-Vedanta, Sabmiller-Fosters and the Sanofi Aventis-Shantha Biotech have tax cases pending in various high courts in the country)

4.) Uncertainty regarding the impact of direct tax laws and allied costs arising after the completion of total project particularly where in the

international transactions, the gestation period of a project is too long ranging from 3 years or more.

5.) The effect of change of government policy due to tax avoidance treaty with other countries resulting in the total darkness regarding tax incidence on their profit after the completion of project. (India is negotiating the tax treaty with Mauritius to prevent evasion of tax. India wants to retain the right to tax capital gain arising to non-resident. India has already started raising tax demands against the companies and many of these cases are being disputed in various courts.)

BRIEFLY, DOUBLE TAXATION, UNRESOLVED TAX DISPUTES, UNCERTAINTY IN THE APPLICATION OF INTERNATIONAL TAX RULES, HEAVY COMPLIANCE BURDENS, ALL CAN ACT AS A BARRIER TO THE EXPANSION OF CROSS-BORDER TRADE AND INVESTMENT, THEREBY HAMPERING INDIA'S GROWTH RATE.

1. 8 OBJECTIVES OF THE STUDY

With a view to extract the gains of globalization and to develop international business in mutual interest, the present study is being undertaken with the following objectives:

1) to examine the role of direct tax laws in the development of International Business.

2) To appraise the Tax Professionals, Tax Executives and Entrepreneurs with the provisions of tax laws, connected with International

Business/International Transactions and enabling them to take advantage of <https://assignbuster.com/basic-principles-of-international-taxation-economics-essay/>

all tax benefits & concessions (set-off & carry forward), rebates (section 89) and reliefs(section 90 & 91), allowances(section 35), deductions (section 80) and exemptions (section 10), available in our tax laws with due compliance of the requisites.

3) To suggest and propose measures to our policy makers that by making lawful amendments in the act, how our International Business can be strengthened.

Broadly speaking, the study would address the following issues:

What are the measures through which our tax professionals can manage their global tax risk and meet cross border obligation?

How our business entities can complete their international transactions peacefully without facing any undue litigation or political harassment and thus maintaining effective relationship with tax authorities.

What are the loopholes in the act which may be twisted by an assessee for their own benefit. It is required to be plugged or explained properly by the government by making amendments in the Finance Act.

The study also intends to make a comparative study of the tax rates of India with a few selected countries to encourage Indian enterprise to deal with countries having comparatively lower rate of tax .

1. 10 LIMITATIONS

Direct tax laws is a wide term which embraces in itself a variety of tax laws but the present study is restricted to Income Tax Act 1961.

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Income tax act 1961 is subject to change every year. This study is based purely on aspects of Income Tax Act 1961, for the assessment year 2012-13.

3) The nature of topic in itself is a big limitation. Till date, lacs and lacs of transactions have taken place in International Business and thousands of cases are pending in various Tribunals, High Courts and Supreme Court, waiting for the judgment. Whenever the final judgment will be pronounced, it will become a law and guiding factor for future policy makers and help for tax planning.

4) Other indirect tax laws like Customs Act, FEMA (DRI) etc. are equally important in international business but we are restricting our study to the Income Tax Act only and leaving the scope for other research scholars willing in the same framework of study.

5) Further, the study has been conducted mainly from the point of view of the tax payer and not from that of the tax assessor or tax collectors, though it may be indirectly helpful to them in formulating appropriate policies and provides a basis for granting fiscal incentives based on national priorities.

1. 11 HYPOTHESIS

1) The policy makers do not foresee at the time of framing the law that new techniques of tax evasion and avoidance may arise. The business houses with their expert legal brains, who are engaged mainly to seek loopholes in the law, take the maximum tax advantage due to the Government policy. They keep themselves within the framework of law but do not fulfil the intentions of the law, thereby tax avoidance arises.

2) The tax executives and business houses usually do not calculate the in depth risk of such transactions which arises due to higher gestation period of project. They calculate the risk by present tax laws and ignore the risk which may arise at the time of conclusion of the transaction,

3) Assessee do not expect any change in the act with retrospective effect.

1. 12 RESEARCH METHODOLOGY

The proposed study is descriptive and analytical in nature where in researcher uses facts or information already available and analyse these to make a critical evaluation of the material. Here researcher has no control over the variables. The researcher can only report what has happened or what is happening along with possible suggestions.

So the study would be based on the various books, journals, Finance Acts, Explanatory Memorandum on the Budget of the Central Government, Reports of the various committees/commissions, Indian Economic Survey, Income Tax Act 1961, Income Tax Rules 1962, various announcements, circulars and notifications of Central Board of Direct Taxes, Budget speeches of Finance Ministers, Reports of Comptroller and Auditor General of India on Direct Taxes, Economic and Political Weekly, newspapers (Economic Times, Financial Express, Business Lines) etc. Moreover, websites of Income Tax Department, Ministry of Finance, Ministry of Statistics and Comptroller and Auditor General of India have also been used for collection and analysis of data.

The methodology may further be modified with the want of the circumstances.

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CONCLUSION

This chapter laid the foundation for the research. It introduced the research problem and research question and hypothesis. Focus is also laid on the review of existing studies, limitation of the study and methodology adopted.

Future outline

In the upcoming chapters, an attempt has been made to discuss various Direct tax instruments which directly help in the development of International Business. These instruments have been specifically provided by our policy makers in our tax laws, keeping in view the national priority for development, growth and employment. At the same time, the need to augment revenue and resources have been duly kept in consideration, being an equal factor for development of the country. Such instruments as have been discussed in our future chapters have contributed its growth values in the development of International Business. These provisions and their impact with broad outlines and suggestions have been discussed in detail.