Tax Hotline

October 23, 2018

DELHI TRIBUNAL: DEDUCTIONS AVAILABLE UNDER A TAX TREATY CANNOT BE DISALLOWED UNDER DOMESTIC LAW

- Income of a permanent establishment has to be computed in terms of the applicable tax treaty
- Deductibility of expenses provided for under a tax treaty would not be subject to restrictions under domestic law
- Where a tax treaty does not restrict deductibility, expense would be deductible in full

Recently, in *DDIT v. Unocol Bharat Ltd*,[1] the Delhi bench of the Income-tax Appellate Tribunal ("**Tribunal**") held that disallowance provisions under the Income-tax Act, 1961 ("**ITA**") cannot be applied when an international tax treaty provided for deductibility of expenses. The Tribunal ruled that in the absence of language to the contrary in the treaty text, deductibility of expenses would be determined solely by the treaty and not with reference to restrictions under the ITA.

BACKGROUND

The taxpayer was a company incorporated in Mauritius as a wholly owned subsidiary of Unocal Corporation, a US entity, to pursue opportunities in the exploration, development, and production of petroleum products and diversified chemicals, and to identify potential business opportunities in the Indian energy sector. It was not in dispute that the taxpayer had a permanent establishment ("**PE**") in India. For the financial year in consideration (FY 1997-98), the taxpayer filed a return of income claiming a loss. At the first stage of assessment, the Assessing Officer ("**AO**") disallowed certain expenses claimed by the taxpayer as follows:

- Deductions in lieu of payments made to employees were disallowed under Section 40(a)(i) of the ITA on the basis that the taxpayer could not furnish the details of names and address of the employees, duration of the stay of each employee in India, and whether income tax had been deducted at source on salaries paid to employees;
- Deductions in lieu of travel and entertainment expenses were disallowed on the basis that the taxpayer could not establish that such expenses were incurred wholly and exclusively for the purposes of business; and
- Deductions in lieu of operating contract payments made to non-residents were disallowed under Section 40(a)(i) of the ITA on the basis that the taxpayer had not withheld any tax on such payments.

On appeal, the Commissioner (Appeals) ("**Commissioner**") reversed the order of the AO, holding that deductibility of expenses would have to be determined in accordance with Article 7(3) of the tax treaty between India and Mauritius ("**Mauritius Treaty**"), which permitted all expenses incurred for the purposes of the business of a PE to be deducted in determining its profits. The Commissioner also deleted the disallowance of travel and entertainment expenses on the factual finding that the taxpayer had in fact submitted adequate evidence in support of its claim for deduction of such expenses.

Aggrieved by the order of the Commissioner, the Revenue appealed to the Tribunal.

RULING OF THE TRIBUNAL

The Tribunal affirmed the order of the Commissioner, observing that since it was not in dispute that the taxpayer had a PE in India under the Mauritius Treaty, all income and expenditure of the PE had to be computed in terms of Article 7 of the Mauritius Treaty, paragraph 3 of which provided as follows:

> "*3. In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the business of the permanent establishment including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere.*"

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The Tribunal observed that since Article 7 allowed *all* expenses incurred for the purposes of the business to be deducted in computing the profits of a PE, disallowances under domestic law could not be imported into the Treaty to restrict deductibility. The Tribunal noted that Article 7(3) of the Mauritius Treaty operated differently from corresponding articles in India's tax treaties with the United States[2] and the United Arab Emirates,[3] both of which permitted expenses to be deducted "*in accordance with the provisions of and subject to the limitations of the taxation laws of*" the source state. Given that no such qualification existed in Article 7(3) of the Mauritius Treaty, the Tribunal concluded that expenditure incurred on employee costs had to be allowed in full while computing the profits of the PE. In coming to this conclusion, the Tribunal relied on the prior ruling in *State Bank of Mauritius v. DDIT (International Taxation)*,[4] which had held that in the absence of restrictive provisions in a tax treaty, expenditure incurred for the purposes of the business of a PE had to be allowed in full. On the same basis, the Tribunal also deleted the disallowance of operating contract payments made to non-residents.

The Tribunal also deleted the disallowance of travel and entertainment expenses based on the factual finding that the taxpayer had in fact provided detailed project wise information on expenses incurred and as such, the AO could not have held that such expenses were not incurred for the purposes of business.

ANALYSIS

The Tribunal has correctly concluded that domestic disallowance provisions cannot be read into a tax treaty while computing profits attributable to a PE constituted under that treaty, absent specific language to that effect in the treaty text. The ruling therefore provides welcome clarity on computation of taxable income in a cross-border scenario and further reaffirms the principle that tax treaties override the ITA to the extent they are more beneficial to a taxpayer. Thus, if a tax treaty provides for a more liberal mode for computation of income, it is that mode that should be followed, notwithstanding any provisions to the contrary in the ITA.[5] However, if a tax treaty contains a restrictive clause, the allowability of the deductions would have to be determined in accordance with that clause.

Interestingly, the 2017 update to the OECD Commentary on the Model Tax Convention on Income and on Capital ("**Commentary**") observes that "*the conditions for the deductibility of expenses are a matter to be determined by domestic law, subject to the provisions of the Convention, and in particular, paragraph 3 of Article 24*",[6] even though the text of the Model Tax Convention ("**MTC**") – which the text of the Mauritius Treaty appears to be based on – is itself silent on deductibility of expenses in computing profits of a PE. Paragraph 3 of Article 24 (the MTC article on non-discrimination) of the MTC requires, among other things, that expenses be deductible under the same conditions whether they are incurred for the purposes of a PE or for the purposes of an enterprise of the relevant source state. Put differently, any expense incurred for the purposes of a PE must not, for tax purposes, be treated less favourably than a similar expense incurred by an enterprise of the relevant source state. A similar view was expressed by the Federal Court of Canada in *Utah Mines Ltd v. Her Majesty the Queen*[7] while disallowing certain royalty payments on the ground that deductions under local law should apply equally to both domestic corporation and PEs in Canada of foreign enterprises.

Prior to July 2010, the MTC did in fact contain a provision identical to Article 7(3) of the Mauritius Treaty, although the Commentary observes that this provision was "*originally intended to clarify that (…) expenses incurred directly or indirectly for the benefit of permanent establishment* [were] *to be taken into account in determining the profits of the permanent establishment, even if these expense had been incurred outside the State in which the permanent establishment was located*".[8] Indeed, in the OECD's view, Article 7 only serves to allocate revenues and expense for the purposes of allocating taxing rights and "*does not prejudge the issue of which revenues are taxable and which expenses are deductible, which is a matter of domestic law*".[9] Although India had previously adopted a position in agreement with this interpretation,[10] it appears to have been curiously omitted from the Commentary as it stands today, rendering India's position on the subject unclear.

Nevertheless, given that several of India's tax treaties contain language subjecting expense deductibility to the laws of the source state, taxpayers should be careful in determining the extent of deductions available in computing income chargeable to tax in India.

– Anandapadmanabhan Unnikrishnan & Ashish Sodhani
You can direct your queries or comments to the authors

[1] Order dated 05.10.2018 in ITA No. 1388/Del/2012 for AY 1998-99.

[2] *See* Article 7(3), India – US Tax Treaty.

[3] *See* Article 7(3), India – UAE Tax Treaty.

[4] [2012] 19 ITR (T) 675 (Mumbai – Trib.).

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[5] *See* DCIT v. CIT Alcatel, [1993] 47 ITD 275 (Delhi); Compagnie Francaise D'Etudes Et De Construction v. IAC, [1984] 8 ITD 215 (Delhi); ITO v. Degremont International, [1985] 11 ITD 564 (Delhi); JCIT v. State Bank of Mauritius Ltd, [2011] 46 SOT 36 (Mumbai) (URO).

[6] OECD, *Commentary on the Model Tax Convention (Condensed Version)*, at p. 183 (2017).

[7] [1991] 1 CTC 387.

[8] OECD, *supra* n. 6, at p. 184.

[9] OECD, *supra* n. 6, at p. 192.

[10] Id., at p. 629, referring to the 2010 version of the Commentary: "Armenia, India, Lithuania and Slovenia reserve the right to add to paragraph 3 a clarification that expenses to be allowed as deductions by a Contracting State shall include only expenses that are deductible under the domestic laws of that State."; See also CBDT Circular No. 5/2004 dated 28.09.2004, at para 5: "Paragraph 3 of the Article provides that in determining the profits of a Permanent Establishment there shall be allowed as deductions expenses which are incurred for the purposes of the Permanent Establishment including executive and general administrative expenses so incurred, whether in the State in which the Permanent Establishment is situated or elsewhere. What are the expenses that are deductible would have to be determined in accordance with the accepted principles of accountancy and the provisions of the Income-tax Act, 1961."

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