

Tax Hotline

March 11, 2024

DISALLOWANCE OF EXPENDITURE FOR FAILURE TO DEDUCT TDS VIOLATES NON-DISCRIMINATION CLAUSE IN DTAAs.

- The Delhi HC held that Article 24(3)/26(3) of the India-Japan and India-USA DTAA is applicable on disallowance of expenditure incurred while paying non residents.
- The HC observed that section 40(a) (prior to its amendment in 2014) did not treat the deductibility of expenses incurred while paying residents vs non residents, under the 'same conditions'.

BACKGROUND

The Delhi High Court ("**HC**")¹ has recently contributed to the evolving jurisprudence on the applicability of the non-discrimination principle incorporated in India's tax treaties. The HC, applying Articles 24(3) and 26(3) of India's tax treaties with Japan and USA respectively ("**DTAAs**"), found that:

- disallowance of expenditure (while determining the taxable profits of a taxpayer) under section 40(a)(i) of the Income-tax Act ("**ITA**"),
- for failure to deduct taxes at source ("**TDS**") on intra-group transactions with non-residents,
- **should not** apply.

The logic is that - similar payments made to residents of India, under the erstwhile provisions of section 40(a)(ii), would not have been subject to TDS. Consequently, the power of the tax authorities to disallow such deductions, would not be applicable.

Thus, the HC found that the provisions of section 40(a) (as it stood then), did not treat the deductibility of expenses incurred (while making such payments to residents, as opposed to non-residents), under the 'same conditions'.

FACTS

The Taxpayer² in the assessment year ("**AY**") 2006-07 remitted payments (in the nature of consideration for purchases), to its non-resident associated enterprises ("**AEs**"), without deducting taxes at source. The AE's were spread across USA, Japan, Thailand, and Singapore. The Assessing Officer ("**AO**") disallowed such payments made by the Taxpayer to its AEs under section 40(a)(i) of ITA, from being claimed as deductible expenditure from the Taxpayer's taxable income.

For section 40(a)(i) to apply, the payment is required to be chargeable to tax under the ITA in the first place (and accordingly subject to TDS). Since the payment was in the nature of 'business income' of the recipient AE (and not interest, royalty, or fee for technical services), the same would be chargeable to tax under the ITA (i.e., subject to withholding taxes under section 195), only if it was attributable to a PE of the recipient AE in India. Accordingly, the AO found all the recipient AE's of the Taxpayer, to have constituted a PE in India; and consequently held that the payments should have been subject to TDS. The failure to deduct such taxes, lead to the disallowance of such payments, at the hands of the Taxpayer.

With respect to the AEs incorporated in Japan and the USA, the Taxpayer did not advance arguments to refute the existence of a PE (i.e., did not contest the AO's disallowance on the ground that these payments were not chargeable to tax in India). Instead, they invoked the non-discrimination provision set out in India's treaties with Japan and USA. Accordingly, the HC restricted its findings in this respect to Article 24 and 26 of the relevant DTAAs.

However, with respect to the AE's incorporated in Thailand and Singapore, the Taxpayer argued the lack of a PE being constituted in India (since India's treaties with Thailand and Singapore do not contain a similar non-discrimination provision). While the High Court ruled in favor of the Taxpayer in this respect, our analysis in this Hotline has been restricted to the applicability of the non-discrimination provisions in India's DTAAs.

DECISION OF THE HC

The language set out in Articles 24(3) and 26(3) of the respective treaties are pari materia, and state that except for as provided in:

Articles 9, 11(7), and 12(8) (of the India US treaty), and

Articles 9, 11(8) and 12(7) (of the India Japan treaty)

(i.e., the treaty provisions dealing with transfer pricing adjustments in transactions between associated enterprises),

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(a) interest, (b) royalties, and (c) other disbursements paid by a resident of India to a non-resident, *for the purposes of determining the taxable profits of the payor in India, shall be deductible under the “same conditions”*, as if they had been paid to a resident of India.

Whether payments made are in the scope of the non-discrimination provision?

The first question is therefore the determination of what constitutes “other disbursements”. The Delhi HC in *CIT vs. Herbalife International India (P.) Ltd*³ interpreted ‘other disbursement’ widely to include payments other than interest and royalties (finding that ‘other disbursements’ do not need to be related to or qualified by the preceding terms). Accordingly, the HC in the present case found payment for purchases made to AEs to also fall within the scope of ‘other disbursements’.

Whether the exception in Article 9 applies, rendering the non-discrimination provision inapplicable?

Given that any transfer pricing adjustments made with respect to the transactions were not the subject matter of the disallowance ordered under section 40(a) of the ITA, the HC found Article 9 to be irrelevant with respect to the applicability of Section 40(a). Accordingly, the exception in the non-discrimination provision did not apply.

Whether deductibility of payments made to residents’ vs non-residents are treated under the “same conditions”?

Prior to the amendments introduced by the Finance Act of 2004, payments specified in section 40(a)(i) made outside India or to a non-resident were not allowed as deductions (while computing the income chargeable to tax under the head “Profits and gains from business and profession”) unless tax had been deducted and deposited. However, the provision did not disallow any such payments made to residents.

Post the Delhi HC’s ruling in *Herbalife*, with effect from April 01, 2005, the provision was amended to apply to residents as well (with the intent to bring parity). For payments to residents, only payments in the nature of any interest, commission, brokerage, fees for professional services, fees for technical services, payments to contractors or sub-contractors, were covered. However, this did not include an all-encompassing term to cover “other sums chargeable to tax under the ITA”, which was the case for disallowing payments to non-residents.

Thus, the scope of the power to disallow payments to residents was still narrower, compared to non-residents (i.e., the ‘specified payments’ covered under both provisions were not in sync). While this disparity in the language was later amended by the Finance Act of 2014, given that that the transaction in question was with respect to AY 2006-2007, the HC found the amended provisions above to also be discriminatory (as it did not treat the deductibility of payments to residents vs non-residents under the “same conditions”).

NDA ANALYSIS

Unfortunately, the HC has not offered significant insight into scope of discriminatory treatment, that is intended to be restricted through the treaty requirement of treating deductions under the “same conditions” (i.e., as per the Article 24(3) or 36(3) of the respective tax treaties).

Non-discrimination provisions generally deal with the elimination of tax discrimination in certain precise circumstances (i.e., discrimination based on specific factors). In this context, the Delhi bench of the ITAT had previously noted (while invoking Article 26(3) in the context of section 40(a)(i)), that a if a tax-payer were given the choice of dealing with a resident or a non-resident in business; they would opt to deal with the resident.⁴ This is because as per section 40(a)(i), the same would not result in a disallowance for non-deduction of tax. To this extent, the ITAT recognized that section 40(a)(i) discriminates against the non-resident.

Disparity in applicability of withholding taxes between residents and non-residents are inherently riddled with practical issues emanating from cross-border taxation. The rationale to withhold taxes at source while making payments to non-residents is that the income of the non-resident is harder to tax at the hands of such non-residents, who have no connection with country of source (making withholding the only realistic opportunity to collect taxes). This is not the same for payments made to residents, that are in any case taxed on their income. The OECD Expert Group in its public discussion draft titled ‘Application and Interpretation of Article 24 (Non-Discrimination)’ too, noted the above practical consideration.

However, as rightly noted by the Delhi HC in *Herbalife*, the contention here is not with respect to the discrimination in applying TDS as a principal (which is based on a legitimate distinction with cogent rationale); but instead, with the consequence of making / failing to deduct the taxes. The question is therefore, under the ‘same conditions’, are the consequences of failure to deduct taxes on payments to residents vs non-residents different? Answering in the positive, the HC found that the objects and purpose of the non-discrimination provision would be defeated if the outcome in both circumstances was different.

The Finance Act of 2014 eliminated the difference in the categories of payments that could be disallowed under section 40(a)(i) of the ITA. However, there is still a difference in the amount of disallowance permitted in the case of payments to residents (i.e., only 30% of such payments would be disallowed), vs payments to non-residents (i.e., 100% of the payments would be disallowed). While such analysis appears to be missing, the HC’s guidance on the scope of ‘same conditions’ in the treaty provision, may have offered valuable insight to determine whether the difference in the percentage of disallowance would also constitute a discrimination (under the treaty). The applicability of the decision in light of the amendment introduced by Finance Act 2014 remains yet to be seen.

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March 19, 2025

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¹CIT vs Mitsubishi Corporation India P. Ltd, ITA No. 180/2014

²Mitsubishi Corporation India P. Ltd

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