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Tax Flash News

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No disallowance of expenditure for non-deduction of tax at source from the payment to the non-resident for purchase of goods applying non-discrimination article under the tax treaty

The Delhi High Court in the case of *Mitsubishi Corporation India P. Ltd*[1] held that the tax officer was not right in disallowing the expenditure due to the non-deduction of tax at source from the payments to non-resident for the purchase of goods prior to 2014 in view of the non-discrimination clause under the India-USA and the India-Japan tax treaties.

With respect to transactions with Singapore and Thailand group entities, the High Court held that these entities did not have a PE in India and thus payment made to them was not chargeable to tax in India. Chargeability to tax was the pre- condition for triggering the obligation to deduct tax. The taxpayer was not obliged to deduct tax at source from payments not chargeable in India.

Relevant provisions of the Act

- Sections 40(a)(i) and 40(a)(ia) of the Income-tax Act, 1961 (the Act) deal with the disallowance of expenditure in cases of non-deduction of tax at source from the payment of that expenditure.
- Prior to 2004, there was section 40(a)(i) only which deals with the disallowance of payments like interest, royalty, fees for technical services (FTS) and 'other sum chargeable under this Act' payable to the non-resident.
- The Finance Act, (the FA) 2004 introduced clause (ia) and extended such disallowance provisions for the payment to resident but its scope was restricted only to specified payments like interest, commission, FTS, etc. and not to other payments.
- The FA 2014 expanded the ambit of disallowance under section 40(a)(ia) by bringing within its scope 'any sum payable to a resident on which tax is deductible at source'.

Relevant treaty provisions

- The non-discrimination clause under the India-USA treaty and the India-Japan treaty provides for equal treatment *qua* deductibility of payments to non-resident and resident persons. It provides that interest, royalties, and other disbursements paid to a non-resident payee shall be deductible under the same conditions as if the sum had been paid to a resident payee. However, the non-discrimination clause does not apply to the cases subjected to transfer pricing norms.

Facts of the case

- During the Financial Year 2005-06, the taxpayer, a resident of India, made payments to its group entities which were residents of the USA, Japan, Singapore and Thailand for the purchase of goods.
- The tax officer held that all the group entities of the taxpayer had a PE in India. The payment for the purchase of goods was taxable as business income in India.
- In the absence of tax deduction at source under section 195 of the Act, the tax officer disallowed the expenditure under section 40(a)(i).
- The tax officer also made some addition on account of an adjustment of arm's length price (ALP).
- For the disallowance of payment to the USA and Japanese entities, the taxpayer relied on the non-discrimination article under the relevant tax treaty as the payment was made prior to 2014 when there was a disparity between sections 40(a)(i) and 40(a)(ia) of the Act.

[1] *CIT* v. *Mitsubishi Corporation India P. Ltd.* (ITA 180/2014) - Source: Taxsutra

- The taxpayer argued that for the year under consideration, while the payment to non-resident for the purchase of goods is covered under section 40(a)(i), the same transaction is not covered under section 40(a)(ia) in the case of payment to a resident. Accordingly, there was discrimination *qua* deductibility of payments to non-resident and resident persons for the purchase of goods and the disallowance under section 40(a)(i) was not correct. The taxpayer relied on the Delhi High Court decision in the case of *Herbal Life International (P.) Ltd.*[2]
- For the disallowance of payment to Singapore and Thailand entities[3], the taxpayer argued that such entities did not have a PE in India. Thus, the income of such entities was not chargeable to tax in India and thus, there was no need of tax deduction at source.
- The Revenue argued that the non-discrimination article was not applicable as that article provides exception to transaction with associated enterprise where transfer pricing provisions are applicable. In this case, the tax officer proposed transfer pricing adjustments and therefore the case was covered by the exception.
- The Revenue further argued that the Delhi High Court decision in the case of *Herbal Life International (P.) Ltd.* is not applicable as the said decision was based on the language of Section 40(a)(i) as it stood in AY 2001-02 i.e., prior to the amendment by the FA 2004. After the insertion of clause (ia) to disallow certain payments made to resident on non-deduction of tax at source, there was no discrimination.
- In the instant case, the judges of the High Court had different opinions. While one judge ruled in favour of the taxpayer, the other judge ruled in favour of the Revenue. Thus, the matter was referred to the third judge.

Third judge - High Court's decision

Transactions with the USA and Japanese entities

- Although the parity was brought by the FA 2004 to deny allowance of the expenditure where tax was not deducted against payments made outside India or to the non-residents and to the residents, it was limited to specified payments. Clause (ia) of section 40(a) did not bring payments made towards purchases to resident vendors within its net. Thus, the discrimination continued even after the introduction of section 40(a)(ia) by the FA 2004.
- This disparity was removed by the FA 2014 when the ambit of disallowance was enlarged by bringing 'any sum payable to a resident' under the disallowance provisions of section 40(a)(ia).
- As the payment was made prior to the amendment by the FA 2014, the amendment is of no relevance in the instance case.
- Thus, the non-discrimination clause would apply to the payment to the non-resident for purchases made by the taxpayer.
- In the instant case, the transfer pricing adjustment impacted the payments against services. This aspect was not the subject matter of the disallowance. The disallowance was with respect to the purchase transaction. Thus, the revenue's argument for the non-applicability of non-discrimination provisions in view of transfer pricing adjustment was not correct.

Transactions with the Singapore and Thailand entities

- These group entities did not have a PE in India and thus the payments made to them were not chargeable to tax in India.
- The taxpayer was not obliged to deduct tax at source from payments made to Thailand and Singapore entities. Chargeability to tax was the pre- condition for triggering the obligation to deduct tax under section 195.
- The reliance on the decision of the Supreme Court in *Transmission Corporation of AP Ltd*[4] was misplaced, as that was a case involving a composite transaction where the trading receipt was embedded with a component of income.

Our comments

The Delhi High in the instant case has dealt with the applicability of non-discrimination provisions under the tax treaty to the disallowance provisions of the Act. The observations of the High Court may help taxpayers having transactions with different countries where a non-discrimination clause is available under the relevant tax treaties. One more aspect the High Court has observed is that chargeability is an important condition for the deduction of tax at source.

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[2] *CIT* v. *Herbalife International India P. Ltd.* [2016] 69 taxmann.com 205 (Del)

[3] Note – There was no non-discrimination article under the India-Singapore and the India-Thailand tax treaties

[4] *Transmission Corporation of AP Ltd.* v. *CIT* [1999] 239 ITR 587 (SC)

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