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International Tax

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High Court holds payments to non-residents as tax deductible pursuant to Non-Discrimination Article under DTAA, notwithstanding provisions of section 40(a)(i)

Snapshot

Single Judge (Third Judge) Bench of Delhi High Court¹ decides upon the issue of invocation of Non-Discrimination Article under a DTAA for disallowance on account of non-withholding of taxes, arising out of conflicting views of the Division Bench, in favor of taxpayer.

HC has taken note of the difference in languages adopted in section 40(a)(i) and the unamended section 40(a)(ia) to hold that disallowances in respect of all payments to non-residents were discriminatory in nature.

HC also reiterated the importance of an income being "chargeable to tax" in order to attract the rigors of tax withholding section 195.

Facts of the Case

Taxpayer entered into several international transactions with its group Companies – four in Japan and one each in US, Thailand & Singapore for purchase of goods as well as intra-group services.

For AY 2006-07, AO disallowed payments made to group companies for 'purchase' transactions u/s 40(a)(i) of the Income-tax Act, 1961 ('the Act') on account of non-withholding of tax u/s 195 of the Act alleging existence of Business Connection and Permanent Establishment ('PE') by not allowing any recourse to Double Taxation Avoidance Agreement ('DTAA'). DRP confirmed the AO's action and did not allow benefit under Non-Discrimination Article ('NDA') on the ground that withholding tax requirements (and related implications on tax deductibility) vis-à-vis non-residents that covered all income chargeable to tax [(section 40(a)(i))] were introduced to put a check on non-resident's tax liability in India and hence, the same could not be considered as discriminatory when compared to withholding tax requirements (and relatively liberal related implications on tax deductibility) vis-à-vis residents that did not provide for disallowance of purchase payments at that point in time [section 40(a)(ia)]. Delhi Bench of ITAT held in favor of the taxpayer by allowing invocation of NDA relying upon Special Bench ruling in the case of *Rajeev Suresh Gajwani v. ACIT [(2011) 129 ITD 145 (Amd)]*².

Against the ITAT decision, Revenue preferred an appeal to High Court ('HC'). The decision was a split wherein both the Judges shared divergent views and hence, matter was referred to Third Judge in the instant case.

The case also involved an issue regarding disallowance on payments made to the Singapore and Thailand based group

¹ CIT - II vs. Mitsubishi Corporation India P Ltd [ITA180/2014]

² We would like to share with our readers that this landmark case of Special Bench in the case of *Rajeev Gajwani* was successfully argued by our Managing Partner, Mr. Milin Mehta.

entities for payments made without withholding any tax, in respect of transactions of purchase of goods, especially in absence of PE.

Revenue's Arguments

Revenue's primary argument was that all non-resident payees had a Business Connection in India and accordingly, there was a requirement on the part of the Taxpayer to withhold tax under section 195 on transactions of purchases. It was argued by the Revenue that since the taxpayer was obliged to withhold tax and it has failed to do so, such expenses are required to be disallowed as per the provisions of section 40(a)(i) of the Act.

The Revenue differentiated the case of Herbalife International India³ with the present facts of the case stating that the decision was considering the provisions of section 40(a)(i) as it stood before the amendments brought in by the Finance Act, 2004. Pursuant to the amendments, payments made to residents were brought within the ambit of section 40(a)(ia) and hence there was no discrimination due to disallowance of deduction concerning payments made to non-residents vis-à-vis residents post the amendments brought in by Finance Act, 2004

Further, the Revenue was of the view that the provisions of Articles 24(3)/26(3) of India-Japan DTAA and India-US DTAA had no application on account of exception of Article 9 (Associated Enterprise). It was argued that the provisions of Article 9 applied in the given case since the transactions were entered into with Associated Enterprises wherein profits from the service transactions were benchmarked and adjustment was made by the Transfer Pricing Officer. Accordingly, Revenue contended that the reliance placed on the judgement of Herbalife International India was misplaced considering the applicability of Article 9 in the given case.

Taxpayer's Arguments

The taxpayer contended that with respect to the disallowance of the purchase transaction with entities in Japan and US, AO violated the non-discrimination provision contained in Article 24(3)/ 26(3) of respective DTAA's executed by India with Japan and USA.

It further argued that the exception provided under Article 24(3) / 26(3) of India-Japan DTAA and India-US DTAA with respect to Article 9 (Associated Enterprise) was not applicable in the given case as there was no transfer pricing adjustment with respect to the transaction of purchase of goods from the Group companies and it was confined to service transactions. Hence, the taxpayer strongly contended that the case was not of Article 9 and thus, the exception to invocation of non-discrimination didn't apply. The taxpayer therefore argued that it was eligible to invoke NDA in respect to allowability of deduction of payments made to non-residents vis-à-vis a resident.

High Court's Decision

Applicability of Non-Discrimination Article

The HC observed that the provisions of NDA with respect to deductibility of expenses in Article 24(3) & Article 26(3) of the India-Japan DTAA and India-US DTAA were similarly worded as under:

*"3. Except where the provisions of Article 9, paragraph 8 of Article 11, or paragraph 7 of Article 12, apply, interest, royalties and **other disbursements** paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned Contracting State."*

It was observed by the HC that the provisions of section 40(a) underwent major changes vide Finance Act 2004 and Finance Act 2014. Vide Finance Act 2004,

³ CIT vs. Herbalife International India Pvt. Ltd. [ITA No. 07/Del/2007 (Delhi HC)]

disallowance of expenses u/s 40(a) of the Act upon non-withholding of tax was also made applicable to payments made to residents in the nature of interest, commission or brokerage, fees for professional services or technical services and contractual payments. However, the scope was restricted to the above nature of expenses only and did not cover within its ambit any other expenses (for example, purchase / sale of goods) chargeable to tax in the hands of the recipient.

Vide Finance Act, 2014, the section was again amended to cover disallowances for all the payments made to residents, chargeable to tax as per the domestic law (It is important to note that even in 2014, there was no requirement to withhold tax on payments pertaining to purchases).

HC noted that the case of the taxpayer was of AY 2006-07 and thus, the amendment brought in by Finance Act 2014 shall have no relevance in the present case. It was held by HC that vide amendments introduced through Finance Act 2004, parity was brought in the provisions of section 40(a) for denying the deduction of the expenses where tax was not withheld at source for the payment made to residents vis-à-vis non-residents, however, such amendment was brought in with respect to only certain payments made to residents which did not include within its ambit 'purchase' transactions. Accordingly, the amended provisions of section 40(a)(ia) of the Act, as it stood on 1st April 2005, did not bring within its net, disallowance with respect to purchase payments made to residents when compared to section 40(a)(i) of the Act.

Accordingly, HC was of the opinion that non-discrimination clause as mentioned in Article 24(3)/26(3) of India-Japan DTAA and India-US DTAA would apply with regards to the payments for purchase of goods from the group entities in Japan and US, and hence, such payments would be tax deductible in the hands of the Taxpayer, even if taxes were not withheld on the same under section 195.

Non-applicability of exception to NDA

HC further negated the argument of the Revenue that the present transactions got covered under the exception to Article 24(3)/ 26(3) of the DTAA as the 'service' transactions fell under Article 9 of the DTAA's.

HC held that disallowance by the AO under section 40(a)(i) was confined to 'purchase' transactions, which had not attracted any transfer pricing adjustment. The transfer pricing adjustment was restricted only to intra-group 'service' transactions. Since the transactions of purchase and services were independent in nature and not composite, Article 9 was not applicable to purchase transactions in the given case and hence, the taxpayer was eligible for the non-discrimination clause as per Article 24(3)/26(3) of India-Japan DTAA and India-US DTAA.

Apart from the above, as regards the transactions with Singapore and Thailand entities, HC observed that the AO was of the view that since such entities constituted Business Connection in India, income accrued or arising from India shall be chargeable to tax in India and the taxpayer was obliged to withhold tax thereupon.

HC held that such entities did not have PE in India and thus, the business income of such non-resident entities would not be taxable in India. HC relied on the provisions of section 90(2) of the Act which states the provisions of domestic law or DTAA, whichever is more beneficial, may be applicable to the taxpayer. Reliance was placed on the Supreme Court judgement in the case of *GE India*⁴ to hold that if the sum is not chargeable to tax in India, the provisions of section 195 is not applicable and consequently there cannot be any disallowance of deduction u/s 40(a)(i) of the Act.

⁴ *GE India Technology Centre Pvt Ltd vs CIT [TS-201-SC-2010-0]*

KCM Comments

With this ruling favoring the taxpayer, HC has settled the dust around applicability of NDA in the context of disallowance in the hands of a resident payer on account of non-withholding of taxes while making payments to non-residents, especially considering the liberal provisions (as existed then) pertaining to disallowances when payments were being made to residents. There are various rulings⁵ wherein a similar principle has been upheld in the past.

It is an accepted principle that additional withholding tax requirements in case of non-resident payments should not be considered as 'discriminating' considering that while in case of resident payees, it could be easier to assess such residents in absence of tax withholding, the same may not hold good when it comes to non-resident payees. However, the same logic cannot be extended to subsequent implications that could impact deductibility of expenses in the hands of a resident payer when payments are made to a resident vis-à-vis a non-resident. Any such differentiation in deductibility of expenses would be considered as 'discrimination'.

The language of the NDA in the DTAA's with respect to allowance of the deduction uses the expression 'interest, royalties and other disbursements' for covering the nature of payments by an entity to a non-resident vis-à-vis a resident. It is now a settled position that the expression 'other disbursement' is to be considered as wide enough to include all the payments (for e.g. purchase transaction in the given case) and the doctrines of *noscitur-a-sociis* and *ejusdem generis* should not be applied.

It is important to note that w.e.f. 01 July 2021, payments to residents for purchase of goods attract withholding tax provisions under the Act. In that scenario, considering the current provisions of section

40(a)(ia), expenses in the nature of purchases from residents would also attract disallowance on account of non-withholding of tax and accordingly, the principle laid down in the judgment may not be directly applicable. However, considering that the current provisions only provide for a 30% disallowance in the case of resident payments as opposed to a 100% disallowance in the case of non-resident payments, there still remains a differentiation in how expenses are deductible when paid to residents vis-à-vis non-residents. Accordingly, the applicability of NDA would continue to be explored by taxpayers in such situations. Another interesting proposition could be invocation of NDA in the context of disallowance of salaries paid outside India or to a non-resident under section 40(a)(iii) which, on a plain reading of the provisions, is a permanent disallowance.

These are issues yet to be tested and it would be interesting to see how judiciary looks at the same in times to come.

⁵ *Honda Cars India Ltd. v. DCIT* [ITA No.375/Del/2016 (Delhi ITAT)], *DCIT v. Abacus Engineering Private Limited* [ITA No. 1698 to 1702/Mds/2010]

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