Lakshmikumaran & Sridharan attorneys

Direct Tax

# amicus

An e-newsletter from
**Lakshmikumaran & Sridharan**, India

November 2017 / Issue–39

## Contents

**Article**
Section 40(a)(ii) and taxes paid abroad – A discussion ................. 2

**Circular** ..................................... 5

**Ratio Decidendi**........................ 5

**November**
**2017**

# Article

## Section 40(a)(ii) and taxes paid abroad - A discussion

By **Gayatri Sridharan**

As per section 5 of the Income Tax Act 1961 (the Act) practically all of a resident assessee's world income enters his total income. In the case of a non-resident assessee, however, his entire world income does not form part of his total income under the Act. His total income is confined only to the income received by him in the taxable territories of India and the income accruing to him or deemed to be accruing to him in the taxable territories of India. *So, what happens to the taxes paid in foreign jurisdictions by the assessee*?

Section 40(a)(ii) of the Income Tax Act , 1961 bars the deduction of "any rates or taxes" payable by an assessee in arriving at the profits liable to tax.

### *Evolution of the Concept:*

Income Tax as we know it represents the crown's share of profits. It is a case of application of profits after they have been earned. In the case of ***Ashton Gas Co***. which went up to the House of Lords and the judgment of Buckley, J., was affirmed in **1906 Appeal Cases, 10**. Earl of Halsbury, L. C., made these observations at page 12 :

> "*Profit is a plain English word; that is what is charged with income-tax. But if you confound what is the necessary expenditure to earn that profit with the income-tax, which is a part of the profit itself, one can understand how you get into the confusion which has induced the learned counsel at such very considerable length to point out that this is not a charge upon the profits at all. The answer is that it is. The income-tax is a charge upon the profits; the thing which is taxed is the profit that is made, and you must ascertain what is the profit that is made before you deduct the tax - <u>you have no right to deduct the income-tax before you ascertain what the profit is.</u> I cannot understand how you can make the income-tax part of the expenditure."*

This was the philosophy behind the insertion of Section 40(a)(ii) of the Income Tax Act,1961 and section 10(4) of the erstwhile Indian Income Tax Act, 1922.

### *Income liable to tax within India*

The issue which then arose for consideration was, whether the income of an assessee taxable within Indian shores is net of tax paid in another country or whether it is the gross income which should be brought to tax?

There was a judicial conflict prior to the enactment of the Finance Act 2006 on whether income-tax paid in a foreign country is eligible for deduction in the computation of profits or gains from business or profession. Some assessees were claiming the income tax paid in a foreign country both as a deduction in the computation of profits and gains from business or profession and as credit against tax payable in India on their global income.

With a view to ending the judicial conflict the Finance Act 2006 inserted an explanation 1 to section 40(a)(ii) of the Income Tax Act clarifying that any sum payable outside India and eligible for relief of tax under section 90 or deduction from the income tax payable under section 91 is

© 2017 Lakshmikumaran & Sridharan, India
All rights reserved

not allowable as a deduction under section 40 of the Income Tax Act.It further clarified that the tax payers will continue to be eligible for tax credit in respect of Income Tax paid in a foreign country in accordance with the provisions of section 90 or as the case may be section 91.

### *Taxes referred to in Sec. 40(a)(ii)*

In ***Lubrizol India Ltd.'s case***[1] ,Hon'ble Bombay High Court took note of the wording of section 40(a)(ii) and disagreed with the assessee's contention that the expression 'tax' is restricted to 'Income-tax' as defined under section 2(43). While doing so, Their Lordships, *inter alia*, observed as follows:

> "*It is significant to note that the word 'tax' is used in conjunction with the words 'any rate or tax'. The word 'any' goes both with the rate and tax. The expression is further qualified as a rate or tax levied on the profits or gains of any business or profession or assessed at a proportion of, or otherwise on the basis of, any such profits or gains. If the word 'tax' is to be given the meaning assigned to it by section 2(43), the word 'any' used before it will be otiose and the further qualification as to the nature of levy will also become meaningless. Furthermore, the word 'tax' as defined in section 2(43) of the Act is subject to "unless the context otherwise requires". In view of the discussion above we hold that the word 'any' tax herein refers to any kind of tax levied or leviable on the profits or gains of any business or profession or assessed at a proportion of, or otherwise on the basis of, any such profits or gains.*"

The Supreme Court[2] in another case while approving the decision of the Bombay High Court in the above case went on to hold that *Surtax* paid would also be disallowable as a deduction under Section 40(a)(ii). In doing so it also distinguished the earlier decisions of the Supreme Court and Privy Council[3] which held that a tax has to be computed in accordance with the provisions of the Act to fall within the mischief of section 40(*a*)(*ii*)[4] The Supreme Court in the case of ***Smith Kline*** explained that, firstly, it may be mentioned, section 10(4) of the 1922 Act or section 40(*a*)(*ii* ) of the present Act do not contain any words indicating that the profits and gains spoken of by them should be determined in accordance with the provisions of the Act. All they say is that it must be a rate or tax levied on the profits and gains of business or profession. The observations relied upon must be read in the said context and not literally or as the provisions in a statute.

### *Purpose of insertion of Explanation to Section 40(a)(ii)*

In all fairness, the intention of the legislature while inserting the explanation at the end of Section 40(a)(ii) seems to be that all those taxes covered by a Double Taxation Avoidance Treaty [hereinafter referred to as Treaty] will receive the treatment accorded to them under the treaty and hence any benefit of reduced rate of taxes or tax credits/exemptions etc. will be available as per the treaty existing between India and the contracting country. Since such tax payments are already availing credit under the treaty they will not be further eligible to be deducted from the Income of the assessee which is subject to tax in India. But this is only the tip of the iceberg. The following among many situations arise chiefly;

- Tax paid abroad– credit allowed under Treaty[Sec90]

---

[1] *Lubrizol India Ltd. v. CIT [1991] 187 ITR 25(Bom)*
[2] *Smith Kline & French (India) Ltd.v. Commissioner of Income-tax*[1996] 219 ITR581(SC)*
[3] *CIT v. Gurupada Dutta [1946] 14 ITR 100(PC)*
[4] *Jaipuria Samla Amalgamated Collieries Ltd. v. CIT [1971] 82 ITR 580(SC)*

© 2017 Lakshmikumaran & Sridharan, India
All rights reserved

- Tax paid abroad- not covered by Treaty because
  - Tax is not covered by the Treaty or
  - There is no Treaty between India & the contracting country[Sec91]

If there is no Treaty between India and the contracting country then the provisions of Section 91 are attracted and benefit is accordingly given. The problem arises when there exists a Treaty between India and the contracting country but the particular tax is not covered.

The Ahmedabad Bench of the Income Tax Appellate Tribunal in a recent judgement[5] found an innovative solution to the vexed question of relief in respect of taxes not covered by a Treaty and not eligible for deduction under Section 37 by virtue of the explanation to Section 40(a)(ii) of the Income Tax Act 1961. In the case on hand the assessee had paid tax both in India and the state of Maryland US. The tax paid in Maryland was the Maryland State Tax. The Indo US treaty gives relief in respect of only Federal Taxes paid in the US. The earlier precedents had held that such taxes are clearly not deductible u/s 37 of the Income Tax Act. The Maryland State Tax is not covered by the treaty either. The Tribunal therefore pointed out relying on an earlier judgment[6] that the fact that a taxpayer is entitled to make a claim, in accordance with a tax treaty provisions, does not disentitle him to make the claim in accordance with the provisions of the Act.

### *What about Section 91?*

The provisions of Section 91 are to be treated as general in application and these provisions can yield to the treaty provisions only to the extent the provisions of the treaty are beneficial to the assessee; that is not the case so far as question of tax credits in respect of State Income Taxes paid in USA are concerned. Accordingly, even though the assessee is covered by the scope of India US and India Canada Tax Treaties, so far as tax credits in respect of Taxes paid in these countries are concerned, the provisions of Section 91, being beneficial to the assessee, hold the field. As Section 91 does not discriminate between State and Federal taxes, and in effect provides for both these types of income taxes to be considered for the purpose of tax credits against Indian Income Tax liability, the assessee is, in principle, entitled to tax credits in respect of the same.

Of course, as is the scheme of tax credit envisaged in Section 91, tax credit in respect of foreign income tax is restricted to actual income tax liability in India, in respect of income on which taxes have been so paid abroad.'

### *Harmonious Interpretation:*

The Tribunal in the above judgement made it clear that the tax treaties are intended to grant relief and not put residents of a Contracting State at a disadvantage vis-a-vis other taxpayers, Section 90 of the Income-tax Act has been amended to clarify any beneficial provision in the law will not be denied to a resident of a contracting country merely because corresponding provision in a tax treaty is less beneficial. If just because there is a tax treaty between India and another country, the benefits of the domestic law provisions are being denied to the assessee, such an interpretation would lead to absurdity and calls for an interpretation harmonious with the scheme of the Income Tax Act.

---

[5] [2017] 86taxmann.com253(Ahmedabad-Trib) Dr Rajiv I. Modi vs DCIT (OSD) Ahmedabad

[6] Tata Sons Ltd. v. Dy. CIT [2011] 10 taxmann.com 87 (Mum.)

© 2017 Lakshmikumaran & Sridharan, India
All rights reserved

### *Conclusion*

This decision gives hope to the a non-resident who is taxed in both jurisdictions but is denied legitimate relief under Section 40(a)(ii).

**[The author is Principal Associate, Direct Tax Practice, Lakshmikumaran & Sridharan, Bangalore]**

# Circular

## Provisions on indirect transfer not to apply on redemption of certain shares or interest outside India

Certain representations were made on the potential for double-taxation on applicability of provisions of indirect transfer in multi-tiered investment structures. While FPI have been specifically exempted, the potential for double taxation at the hands of a non-resident, on redemption of shares or interest held in an Investment Fund, Venture Capital Fund or Venture Capital Company when redeemed in an upstream entity remained an issue. The CBDT, *vide* Circular No. 28/2017 dated 7-11-2017, has clarified that provisions of Section 9(1)(i) read with Explanation 5 pertaining to indirect transfers shall not apply in respect of income accruing or arising to a non-resident on account of redemption or buyback of its share or interest held indirectly though upstream entities in specified funds. The income should accrue or arise from or in consequence of transfer of shares or securities held in India by specified funds and such income should be taxable in India. A non-resident who invests directly in the specified funds shall continue to be taxed as per applicable provisions of the IT Act. The Circular also states that the exemption shall apply only if the proceeds of redemption or buy back arising to the non-resident do not exceed the pro-rata share of the non-resident in the total consideration realised by the funds on transfer of shares and securities in India.

# Ratio Decidendi

## Refund 'due' under Section 244A includes discretionary waiver of interest

The assesse was granted partial waiver of interest by the Settlement Commission by relying on circular of CBDT. The Assessing Officer refused to grant interest on refund on the ground that the provisions of Section 244(A) do not provide for payment of interest on refund due on account of waiver of interest that is charged under Sections 234(A)-(C) of the Act and second, that the power assumed by the Settlement Commission for waiver of interest, by following the CBDT circular referred to, does not enable the Commission to provide for payment of interest under Section 244(A). The Hon'ble Apex Court discussed the provisions of Section 244(A) which provides for manner of calculation of simple interest where refund of any amount becomes due to the assessee under this Act, and which he, subject to the provisions of this section, is entitled to receive, in addition to the said amount.

© 2017 Lakshmikumaran & Sridharan, India
All rights reserved

The Hon'ble Court relied on the judgment of *Union of India* v. *Tata Chemicals Ltd*. [2014 (6) SCC 335] where the court had held that a general right exists in the State to refund any tax collected for its purpose, and a corresponding right exists to refund to individuals any sum paid by them as taxes which are found to have been wrongfully exacted or are believed to be, for any reason, inequitable and held that right to refund exists in the assessee. The Court held that the expression "due" in Section 240 and 244(A) only means that a refund becomes due if there is an order under the Act which either reduces or waives tax or interest. It is of no matter that the interest that is waived is discretionary in nature and the moment that discretion is exercised, a concomitant right springs into being in favour of the assessee. [*K. Lakshmanya & Co* v. *Commissioner of Income-tax*, [2017] 87 taxmann.com 190 (SC)]

## ICDS as notified by the Executive (Central Government) cannot override binding judicial precedents or provisions of the Act

The Delhi High Court recently examined the challenge to constitutional validity of the Income Computation and Disclosure Standards notified by the CBDT. The petitioners urged that the ICDS was a case of excessive delegation of legislative powers and the standards as notified sought to overide binding judicial precedents and in certain cases expanded the ambit of income beyond what was provided in the Income Tax Act, 1961 (the Act). The Delhi High Court held that Section 145(2) as amended has to be read down to restrict the power of the central government to notify ICDS that do not seek to override binding precedents or provisions of the Act. As regards the challenge to particular standards, the Court held as under :

(i) ICDS I which states that the prudence is not to be followed unless specified is invalid. An instance pointed out by the petitioners was that ICDS I states that expected loss and marked to market losses are not be recognised or allowed whereas the concept of prudence is inherent in Section 37 (1) of the Act which allows deduction of expended 'laid out' or 'expended' for the purpose of business.

(ii) ICDS II on valuation of inventories in case of dissolution of a firm does not distinguish between scenarios when the business of the firm is continued and when the business is discontinued. AS per binding precedents, if the business is not discontinued, the stock-in-trade has to be valued a cost or market value whichever is lower. As notified, ICDS II states that inventory shall be valued a net realizable value and is ultra vires the Act.

(iii) ICDS III as notified states that the retention money in construction contracts would be assessed to tax based on proportionate computation whereas judicial exposition has been that the retention money does not accrue to the assesse until and unless the defect liability period is over and the Engineer-in-Charge certified that no liability is attached to the assesse. Para 10(a) of ICDS III has been held to be ultra vires as it seeks to bring to tax retention money the receipt of which is uncertain, at the earlies possible stage. Also para relating to non-deduction of incidental income from borrowing cost and recognition of export claim if there is 'reasonable certainty' (Para 5 of ICDS IV) have been struck down

(iv) ICDS IV, para 6 permitting only proportionate completion method though contract completion method is also a recognized method, has been held to be ultra vires the Act.

(v) ICDS VI stating that marked to market losses in case of foreign currency derivatives held for trading or speculation are not be allowed, has been struck down.

© 2017 Lakshmikumaran & Sridharan, India
All rights reserved

(vi) Validity of Para 8(1) of ICDS IV has been upheld while ICDS on recognizing government grants not later than date of receipt, variance from AS as regards valuation of securities have been struck down.

[*The Chamber of Tax Consultants & Anr* v. *UOI & Ors*, W.P. (C)5595/2017, CM APL 23467/2017, Delhi High Court judgement dated 8-11-2017]

## Compensation received for breach of right of first refusal for starting business is a capital receipt

The assessee company had received a sum of Rs. 16.05 crores as compensation for breach of Right of First Refusal. As per the agreement between assessee and the payer – a soft drink major the assessee had the right of first refusal. The bottling activities were to be carried out by the assesse company in Bangalore. Later, the payer breached the Right of First Refusal article in the agreement and set up its own bottling plant. A settlement was arrived at by which compensation was paid to the assessee company. The AO held that the compensation received by the assessee company was a revenue receipt and therefore, was taxable in its hands. The High Court agreed with the order of the Tribunal that the compensation received was a capital receipt. The Tribunal had held that the right of first refusal is a substantial right and the foundation on which the assesse could have built its bottling business. If such right had been assigned to the assesse, it would have been source of income and profit making apparatus. Therefore, the compensation was a capital receipt since there was no transfer for extinguishment of any rights, it does not amount to capital gains. [*Commissioner of Income-tax* v. *Parle Soft Drinks*, 2017 (11) TMI 1311 (Bombay)]

## Consideration for grant of sub-license without extinguishment of licensor's right is taxable as business income

The assessee had been granted exclusive, non-transferable rights in certain patented technology to manufacture automobile components. It was also authorised to sub-license the technology and accordingly it entered into an agreement with a company in Iran for transfer of license and technology. The assessee claimed that the consideration received by it was taxable as capital gains since it had transferred property – the right to the technology along with certain knowhow, data and experience developed by it. However, the department was of the view that since the assessee was not the owner of the technology and there was no extinguishment of rights in the technology, the income would not be taxable as capital gains but as business income. The Tribunal agreed with the stand of the department. It held that since the assessee as a licensee possessed only the right to use the technology which it shared with the Iranian entity and there was no extinguishment of rights of the transferor and vesting or rights in transferee, the consideration was not taxable under the head capital gains. [*DCIT* v. *Bosch Limited*, ITA 750 & 751/Bang/2014, ITAT, Bengaluru, Order dated 6-11-2017]

## Transfer of assets to non-resident is an essential condition to invoke Section 93

A wholly owned subsidiary (WOS) of the assessee based in Mauritius, sold certain shares to an Indian company. The assessee had also sold shares of the company held by it to the same buyer and offered the gains on sale to tax. The Revenue Authorities (RA) sought to tax the gains on sale of shares by the WOS also at the hands of the assessee as capital gains invoking Section 93 of the Income Tax Act, 1961. Briefly, Section 93 provides that where there is a transfer

© 2017 Lakshmikumaran & Sridharan, India
All rights reserved

of assets whereby any income becomes payable to a non-resident and the transferor acquires power to enjoy the income, it shall be deemed to be income of the transferor. The Tribunal held that Section 93 being a deeming section, has to be construed strictly and since there is no transfer of property by a resident to a non-resident, the section would not apply. It noted that the section deals with the consequences flowing from transfer of assets rather than the transfer of assets itself. [*Tata Industries Ltd* v. *ACIT*, 2017 87 taxmann.com 240 (Mumbai – Trib.)]

© 2017 Lakshmikumaran & Sridharan, India
All rights reserved

**NEW DELHI**
5 Link Road, Jangpura Extension,
Opp. Jangpura Metro Station,
New Delhi 110014
Phone : +91-11-4129 9811
-----
B-6/10, Safdarjung Enclave
New Delhi -110 029
Phone : +91-11-4129 9900
E-mail : lsdel@lakshmisri.com

**MUMBAI**
2nd floor, B&C Wing,
Cnergy IT Park, Appa Saheb Marathe Marg,
(Near Century Bazar)Prabhadevi,
Mumbai - 400025
Phone : +91-22-24392500
E-mail : lsbom@lakshmisri.com

**CHENNAI**
2, Wallace Garden, 2nd Street
Chennai - 600 006
Phone : +91-44-2833 4700
E-mail : lsmds@lakshmisri.com

**BENGALURU**
4th floor, World Trade Center
Brigade Gateway Campus
26/1, Dr. Rajkumar Road,
Malleswaram West, Bangalore-560 055.
Ph: +91(80) 49331800
Fax:+91(80) 49331899
E-mail : lsblr@lakshmisri.com

**HYDERABAD**
'Hastigiri', 5-9-163, Chapel Road
Opp. Methodist Church,
Nampally
Hyderabad - 500 001
Phone : +91-40-2323 4924
E-mail :lshyd@lakshmisri.com

**AHMEDABAD**
B-334, SAKAR-VII,
Nehru Bridge Corner, Ashram Road,
Ahmedabad - 380 009
Phone : +91-79-4001 4500
E-mail : lsahd@lakshmisri.com

**PUNE**
607-609, Nucleus, 1 Church Road,
Camp, Pune-411 001.
Phone : +91-20-6680 1900
E-mail :lspune@lakshmisri.com

**KOLKATA**
2nd Floor, Kanak Building
41, Chowringhee Road,
Kolkatta-700071
Phone : +91-33-4005 5570
E-mail : lskolkata@lakshmisri.com

**CHANDIGARH**
1st Floor, SCO No. 59,
Sector 26,
Chandigarh -160026
Phone : +91-172-4921700
E-mail :lschd@lakshmisri.com

**GURGAON**
OS2 & OS3, 5th floor,
Corporate Office Tower,
Ambience Island,
Sector 25-A,
Gurgaon-122001
phone: +91-0124 - 477 1300
Email: lsgurgaon@lakshmisri.com

**ALLAHABAD**
3/1A/3, (opposite Auto Sales),
Colvin Road, (Lohia Marg),
Allahabad -211001 (U.R)
phone . +91-0532 - 2421037, 2420359
Email:lsallahabad@lakshmisri.com

**Disclaimer:** *Direct Tax Amicus* is meant for informational purpose only and does not purport to be advice or opinion, legal or otherwise, whatsoever. The information provided is not intended to create an attorney-client relationship and not for advertising or soliciting. Lakshmikumaran & Sridharan does not intend to advertise its services or solicit work through this newsletter. Lakshmikumaran & Sridharan or its associates are not responsible for any error or omission in this newsletter or for any action taken based on its contents. The views expressed in the article(s) in this newsletter are personal views of the author(s). Unsolicited mails or information sent to Lakshmikumaran & Sridharan will not be treated as confidential and do not create attorney-client relationship with Lakshmikumaran & Sridharan. This issue covers news and developments till 23rd November, 2017. To unsubscribe, e-mail Knowledge Management Team at **newsletter.directtax@lakshmisri.com**

**www.lakshmisri.com** **www.gst.lakshmisri.com**
**www.addb.lakshmisri.com** **www.lakshmisri.cn**

© 2017 Lakshmikumaran & Sridharan, India
All rights reserved