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Contents

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Article

TDS default on payments made to non-residents – Disallowance @ 30%?

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Background

Tax reforms can play a decisive role in supporting growth, by removing distortions, enhancing transparency and ensuring certain level of stability in the area of international taxation. Indian economy has grown at an impressive pace over the past couple of decades as a result of wide-ranging structural reforms however lack of a stable tax regime has raised concerns about it in the last couple of years. Amidst these concerns, the newly elected government received a massive mandate, with the first promising task of reviving the economy and boosting the sentiments of the foreign investors with a more stable, transparent and *non-discriminatory* tax system.

The recent amendment proposed in Section 40(a)(ia) of the Income Tax Act *vide* Finance Act (No.2) 2014 provides that, the disallowance on account of failure to deduct tax at source shall be restricted to 30% of the amount of expenditure in case of payments made to a resident. The amendment would be effective from April 1, 2015. The memorandum explaining the Finance (No. 2) Bill, 2014 also reiterates: *"In order to reduce the hardship, it is proposed that in case of non-deduction or non-payment of TDS on payments made to residents as specified in section 40(a)(ia) of the Act, the disallowance shall be restricted to 30% of the amount of expenditure claimed."*

An attempt to articulate a tax mechanism with economic objectives sometimes inadvertently results in unintended consequences. This short write-up highlights the concerns hovering over the proposed amendment in Section 40(a)(ia) of the Act which restricts the disallowance of expenditure wherein tax has not been duly deducted at source to 30% of such expenditure *only where* expenditure involves *payments to residents.*

The proposed amendment discriminates between the treatment of payments to residents from payments to non-residents since clause (i) of Section 40(a) which deals with non-residents has not been correspondingly amended to provide for a similar reduced disallowance. This article examines the possibility of extending similar treatment to payments to non-residents by invoking non-discriminatory article of double tax avoidance agreements ('tax treaties').

Legal framework and analysis

Non-discrimination articles in tax treaties obligate the contracting states to prevent a less favourable taxation to nationals and residents of other states, and can be broadly categorized as following: (1) nationality based discrimination; (2) permanent establishment based discrimination; (3) discrimination based on status of payee; and (4) ownership based discrimination. In the present issue under consideration we are concerned with the third category of non-discrimination. The text of relevant Article [Article 24(4) of the OECD Model] is reproduced hereunder:

> "4. Except where the provisions of paragraph 1 of Article 9 (Associated Enterprises), paragraph

7 of Article 11 (Interest), or paragraph 8 of Article 12 (Royalties and Fees for Included Services) apply, interest, royalties, and other *disbursements paid* by resident of a Contracting State *to a resident of the other Contracting State shall,* for the purposes of determining the taxable profits of the first mentioned resident, *be deductible* under the same conditions *as if they had been paid to a resident* of the first mentioned State."

This paragraph is designed to end a particular form of discrimination resulting from the fact that in certain countries the deduction of interest, royalties and other disbursements are allowed without restriction when the recipient is resident but restricted or prohibited when he is a non-resident[1].

In view of the above, disbursements made to a resident of the other contracting state should be deductible in the same manner and to the same extent as if it were payments to a resident of the same state. Thus it prevents indirect discrimination which would arise if the sums were not deductible[2].

The applicability of the above Article has been dealt with in various decisions rendered in the context of erstwhile regime of Section 40(a)(i). To trace the history, Section 40(a)(i) of the Act, has been in the statute book since inception of the Income-tax Act, 1961. A similar provision existed even in the earlier 1922 Act. The provision initially used to cover payments in the nature of 'interest' only. However, in the year 1989, its ambit was widened to cover 'royalty' and 'fees for technical services' also. Thereafter, in the year 2004, with a view to augment compliance of TDS provisions in the case of *residents* as well, a new provision Section 40(a)(ia) [akin to Section 40(a)(i)] was introduced in the Act.

In the context of these changes, a ground for the first time was assailed before the Delhi ITAT in *Herbalife International India (P.) Ltd.* v. *ACIT*[3], alleging that payment of administrative fee to the parent company, an entity in the US, without deduction of tax in the assessment year 2000-01 could not be disallowed by invoking the provisions of Section 40(a)(i) of the Act, in view of non-discriminatory provisions as contemplated in Article 26(3) of the Indo-US Tax Treaty. The Tribunal observed that the provisions of Section 40(a)(i) of the Act as it existed prior to the amendment in the year 2004 provided for disallowance of payment made to a non-resident only. A similar payment to a resident did not result in disallowance in the event of default of TDS. Therefore, a '*resident left with a choice of dealing with a non-resident or a resident in business would opt to deal with a resident rather than a non-resident owing to the provisions of Section 40(a)(i)'* and *a non-resident was discriminated to this extent.* The Tribunal further held that Article 26(3) of Indo-US Tax Treaty seeks to protect against such discrimination and says that deduction should be allowed on the same condition as if the payment were made to a resident. In view of the Tribunal,

1 Page 411 of Double Tax Conventions & International Tax Law (Second Edition) by Philip Baker

2 Pg 396, 397 of Double Tax Conventions & International Tax Law (Second Edition) by Philip Baker

3 (2006) 101 ITD 450 (Del.)

this Article mitigates the rigour of the provisions of Section 40(a)(i) of the Act. The Tribunal, therefore, held that in view of Article 26(3) of Indo-US Tax Treaty, the revenue authority could not seek to invoke the provisions of Section 40(a)(i) of the Act to disallow the expenditure even on the assumption that the sum in question was chargeable to tax in India.

This *ratio-decidendi* was later followed by many other Benches of the Tribunal in the cases like *DCIT* v. *Incent Tours (P.) Ltd.*[4], *Millennium Infocom Tecnologies Ltd.* v. *ACIT*[5], *Sandoz (P.) Ltd.* v. *Addl. CIT*[6], *Central Bank of India* v. *DCIT*[7], *B4U International Holdings Ltd.* v. *DCIT*[8], *Mitsubishi Corporation India (P.) Ltd.* v. *ACIT*[9] and *Asianet Communications Ltd.* v. *DCIT*[10].

Conclusion

Applying the above proposition as accepted in *Herbalife* and other decisions (supra), there appears to be strong judicial support for the view that even in case of payments to non-residents, protected by non-discriminatory article, the disallowance for non-deduction of TDS has to be restricted to 30%. Moreover, in none of these judgments any strong argument has been taken by the department and even explanation 1 to Section 90 of the Act is not suitably worded to guard such a 'deductibility non-discrimination'.

It is important, however, to note that not all treaties have a non-discrimination article[11]. Further some tax treaties though have a non-discrimination article but do not contain an equivalent clause on 'discrimination based on status of payee'[12]. Hence, the legal position highlighted above can be invoked only in the case of select treaty countries[13] having the relevant non-discrimination clause in the treaties.

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Circular

Clarification regarding taxation of AIFs having status of 'non-charitable trusts'

By way of Circular No. 13/2014, dated 28-7-2014, the CBDT has clarified that where the trust deed either does not name the investors or their beneficial interests, the entire income of the Alternate Investment Fund (AIF – 'Fund') shall become liable to be taxed under Section 164(1) at Maximum Marginal Rate in the hands of the trustees in their capacity as 'representative taxpayer' and in such cases, provisions of Section 166 of the Act need

4 (2012) 53 SOT 308 (Del) (URO)
5 (2009) 117 ITD 114 (Del)
6 (2013) 34 taxmann.com 280 (Mum – Trib.)
7 (2010) 42 SOT 450 (Mum)
8 (2012) 148 TTJ 237 (Mum)
9 (2014) 62 SOT 58 (Del) (URO)
10 (2010) 38 SOT 158 (Chennai)
11 For example Australia, Greece, Oman and Saudi Arabia
12 For example Brazil, Canada, Italy, Mauritius
13 For example China, France, Germany, Japan, Netherlands, South Africa, Spain, Swiss Confederation, USA, etc.

not be invoked in the hands of the investors. However, in case of those Funds where names of the beneficiaries and their interests in the Fund are stated in the trust deed, the tax on whole of the income of the Fund consisting of or including profits and gains of business, would be leviable upon the trustees, being 'representative taxpayer' at the Maximum Marginal Rate in accordance with Section 161(1A) of the Act. The aforesaid clarification shall not be operative in the jurisdictions where High Courts have taken a contrary decision.

Ratio decidendi

Advancement of loan for conversion into equity is not subject to transfer pricing

The taxpayer had advanced certain monies to its subsidiaries outside India, which were at a later time, converted into equity investment in the subsidiaries. In Form 3CEB, the transaction was however reported erroneously as advance of monies to the subsidiary. The Revenue Authority ('RA') sought to impute notional interest on these amounts alleging the same to be loans. However the ITAT held that the transaction was in the nature of investment in a subsidiary which cannot be regarded as an 'international transaction' and hence cannot be subjected to transfer pricing. [*Prithvi Information Solutions Ltd* v. *ACIT*, ITA 1816/Hyd/2012, ITAT, Hyderabad, Order dated 8-8-2014]

DRP cannot remand references made to it back to the Assessing Officer

The taxpayer, a non-resident, claimed that it was not liable to taxes in India as it did not have a Permanent Establishment ('PE') in India. The RA, however, held that the taxpayer had a PE in India in the draft order passed by it. The taxpayer preferred a reference before the Dispute Resolution Panel ('DRP') alleging that it did not have a PE. Without giving any specific findings, the DRP remanded the matter to RA, directing him to look into specific facts and evidences. The ITAT however held that the statute provided sufficient power to DRP for considering all material placed before it and hence the DRP is required to give categorical direction to the RA for passing the assessment order. The ITAT further held that the DRP cannot delegate its authority back to the RA. [*Swiber Offshore Construction Pte. Ltd.* v. *ACIT.* ITA 7724/Mum/2012, ITAT, Mumbai, Order dated 6-8-2014]

Company with abnormal profits cannot be a comparable in TP study

The taxpayer provided certain IT enabled support services to its associated enterprise ('AE'). In the transfer pricing assessment, the RA considered 'Eclerx Services Ltd' ('Eclerx') as a comparable to the taxpayer. The ITAT however rejected this company as comparable observing that Eclerx was operating at an abnormally high profit of 89.36% when compared to other comparables, whose highest operating profit was only 33%, almost 1/3rd of the margin of Eclerx. The ITAT also observed that the higher capital infrastructure investment of Eclerx resulted in abnormal profit. [*ACIT* v. *Brigade Corporation India Pvt. Ltd*, ITA 358/Mds/2013, ITAT, Chennai, Order dated 4-7-2014]

Company with big brand value when not a comparable in TP study

The taxpayer provided certain IT enabled services to its AE as a captive contract service provider. In the transfer pricing assessment, the RA considered Infosys BPO Ltd ('Infosys BPO') as a comparable company, to which the taxpayer objected on the ground that the comparable had significantly high turnover than the taxpayer and that it had augmented significantly valuable brand through a brand building process. ITAT did not agree with the taxpayer to reject Infosys BPO on the basis of high turnover. However, the Tribunal observed that Infosys BPO, though did not have super normal profits, did have a big brand value and therefore should be regarded as functionally dissimilar to companies with significantly lesser turnover and should not generally be regarded as a comparable in a transfer pricing assessment. [*Capital IQ Information Systems (India) Pvt. Ltd* v. *ACIT* ITA 124/Hyd/2014, ITAT, Hyderabad, Order dated 31-7-2014]

Multiple, interlinked or inter-related transactions can be combined in determining ALP

The taxpayer was engaged in the manufacturing of automobiles and trading of auto components for which it purchased various spares and components from its AE. It had also paid royalty to its AE. In its transfer pricing study, the taxpayer had aggregated all these transactions as closely related transactions and determined Arm's Length Price ('ALP') at the entity level. In the transfer pricing assessment, the RA observed that manufacturing and trading activities have distinct functions and cannot be combined for determining ALP. The ITAT referred to Rule 10A(d) of the Income Tax Rules, 1962 which provided that 'transaction' could include a number of closely linked transactions and observed that ALP can be determined by aggregating international transactions which are multiple, interlinked or inter-related to each other. Considering the facts, the ITAT upheld the 'combined transaction approach' adopted by the taxpayer. [*Toyota Kirloskar Motor (P) Ltd* v. *ACIT*, ITA 1315/Bang/2011, ITAT, Bangalore, Order dated 11-7-2014]

Conditions for eligibility need to be fulfilled only in the initial year for Section 80-IB

The taxpayer was denied deduction under Section 80-IB of the Act as during the relevant year it lost its SSI status. The High Court observed that, it is not mentioned in the provision, that the conditions mentioned in Section 80-IB has to be fulfilled by the taxpayer for all the 10 years. The High Court further held that merely because an industry stabilizes early, makes profits and loses its SSI status, benefit under Section 80IB cannot be denied and adoption of such literal interpretation would run counter to the very object of granting incentives. [*Ace Multi Axes Systems Ltd.* v. *DCIT*, ITA No. 477 of 2013, Karnataka High Court, Judgment dated 28-7-2014]

STPI unit does not lose its character even if some of the activity is done outside STPI

The taxpayer, owner of the STPI unit, had earlier initiated the development work on '*basic engine*' in Mumbai (outside STPI) which was later transferred to the STPI unit and further with the help of third party tools viz., GUI, skin crafter, digital library, etc., developed and exported the final product and claimed Section 10A deduction thereon. The Revenue (Income Tax Department) denied deduction holding that the substantial development of the software was carried outside the STPI and using third party tools. Allowing the deduction the Tribunal noted that the '*basic engine*' developed and the '*final product*' developed are distinguishable marketable products. It also placed reliance on the EXIM Policy to infer that not everything is to be done within one's own premises to develop the software. [*Ajay Agarwal (HUF)* v. *ITO*, ITA No. 295 of 2014, ITAT, Mumbai, Order dated 25-7 -2014]

Section 14A disallowance on account of interest not valid where interest free funds exceed investments in tax free securities

The finding of the fact given by the Tribunal, in the present case, was that the taxpayer's own funds and other non-interest bearing funds were more than the investment in the tax-free securities. The High Court after relying on the judgment in *Reliance Utilities and Power Ltd.* held that, it would have to be presumed that the investment made by the taxpayer would be out of interest free funds available with him, therefore no disallowance on account of interest can be made under Rule 8D read with Section 14A. [*CIT* v. *HDFC Bank*, ITA No. 330 of 2012, Bombay High Court, Judgment dated 23-7-2014]

'Commercial expediency' necessary for allowance of interest pertaining to borrowed funds utilized in acquiring stake in foreign company

The taxpayer acquired a controlling stake in a company incorporated in British Virgin Islands and for this purpose the funds were borrowed. The issue arose as to whether interest expenditure is allowable. The High Court held that, the interest paid on the borrowings utilized for investments in a foreign company could not be allowed as deduction after observing that the same was not in the course of taxpayer's business. It was also noted that since the taxpayer already had an agent in that zone, the interest paid on borrowed funds was not for the purpose of the business of the taxpayer. [*Crescent Organics Pvt. Ltd* v. *DCIT*, ITA No. 337 of 2012, Bombay High Court, Judgment dated 30-7-2014]

Amendment to Section 40(a)(ia) by Finance Act, 2010 is retrospective

Amendment to Section 40(a)(ia) of the Income Tax Act by Finance Act, 2010, which provides for deductibility of expenditure if TDS is paid within the due date of filing of return, is retrospective in nature. The Revenue's contention was that since it is expressly stated in the Finance Act, 2010 that the said provision would come into effect from April 1, 2010, it was not permissible for tribunals and courts to give it retrospective effect. However, the High Court held that the said amendment is curative in nature and therefore has to be given a retrospective effect. [*CIT* v. *Santosh Kumar Shetty*, ITA No. 590 of 2013, Karnataka High Court, Judgment dated 15-7-2014]

Completion certificate cannot be insisted in areas where laws do not mandate the same

Section 80-IB benefit was denied to the taxpayer on the ground that it did not comply with the conditions as stipulated in clause (10) of the Section 80-IB inasmuch as the valid completion certificate was not obtained and submitted before the Revenue. On these facts, the High Court noted that the municipal corporation of the state had no provision for issue of completion certificate and therefore the taxpayer had gone to the village panchayat (being the local authority) within whose limits the property was situated, obtained and submitted the same before the Revenue for claiming the benefit. The High Court held that when the statute does not provide for issue of such a certificate, Revenue was asking the taxpayer to do something which was impossible and the same was not proper in law. [*CIT* v. *Ittina Properties Pvt. Ltd.*, ITA No. 556 of 2013, Karnataka High Court, Judgment dated 15-7-2014]