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Direct Tax Alert

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Delhi High Court allows deduction despite non deduction of TDS applying non-discrimination clause

The Delhi High Court[1], applying '*non-discrimination clause*' under India-USA and India-Japan Double Tax Avoidance Agreement ('DTAA' or 'treaty'), allows deduction in respect of payments to non-resident towards purchase of goods despite the fact that taxes were not deducted at source in India. The Delhi High Court also held that the withholding provisions under section 195 of the Income-tax Act, 1961 ('the Act') shall apply only if the sum is chargeable to tax in India as per the domestic tax laws read with the treaty.

Background

- The taxpayer, a company incorporated in India is part of multinational group. During the previous year 2005-06 relevant to assessment year 2006-07, the taxpayer purchased goods from its seven associated enterprises resident of USA, Japan, Singapore, and Thailand. The taxpayer also provided intermediary services between the ultimate customers in India and group companies.
- During the assessment proceedings, the Assessing Officer ('AO') observed that MC Japan (one of the group companies) had liaison office in India, which qualifies as permanent establishment ('PE') and hence, payment to MC Japan should be subjected to withholding under section 195 of the Act. Further, since the other

[1] *CIT* v. *Mitsubishi Corporation India P. Ltd.* ITA No. 180/2014 – Third Judge

group companies also follow identical business model, AO concluded that all the group companies had PE in India and payment to such non-residents would attract withholding under section 195 of the Act.

- Accordingly, AO framed draft assessment order disallowing the purchase consideration paid to non-resident associated enterprise under section 40(a)(i) of the Act, for failure to deduct taxes at source. The AO also proposed addition on account of transfer pricing adjustment for the intermediary services provided to group companies.
- The non-discrimination clause under India-USA treaty (Article 26) and India-Japan treaty (Article 24) provides for equal treatment qua deductibility of payments to non-resident and resident persons. As per the non-discrimination article, interest, royalties, and other disbursements paid to 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 under Article 9 (Associated Enterprises) of the respective treaties.
- The objections against the draft assessment order were rejected by the dispute resolution panel.
- Aggrieved by the order, the taxpayer preferred appeal before the Income Tax Appellate Tribunal ('ITAT'). The ITAT allowed the appeal of the taxpayer by granting relief by deleting the disallowance.

Contention of the Revenue

- All the group entities to whom the taxpayer had made payments had business connection in India, therefore, in light of Supreme Court ruling in the case of ***Transmission Corporation of AP Ltd.* v. *CIT***[2], the taxpayer was obliged to deduct taxes at source from the sums 'chargeable to tax' under the Act. Since the taxpayer has not deducted taxes at source, under section 40(a)(i), the deduction should be disallowed.
- A person resident in India, cannot invoke the non-discrimination clause under DTAA.
- The non-discrimination clause under Article 24(3) of India-Japan treaty and Article 26(3) of India-USA treaty are not applicable, as the transactions are covered in one of its exceptions i.e. subjected to transfer pricing provisions under Article 9 (Associated Enterprises) of respective treaties.
- The ratio laid down by Delhi High Court in its earlier ruling in the case of ***Herbalife International India (P.) Ltd***[3] holding section 40(a)(i) as discriminatory pursuant to Article 26(3) of India-USA treaty, is no more applicable with effect from 1 April 2005, post introduction of section 40(a)(ia), disallowing payments to

[2] [1999] 239 ITR 587 (SC)

[3] [2016] 69 taxmann.com 205 (Delhi)

resident persons without withholding applicable taxes at source.

- Further, since the obligation to deduct tax at source applies equally towards payments made to residents and non-residents, especially after the insertion of Explanation 2 to Section 195, the discrimination ceases to exist.
- Provisions of DTAA relating to non-discrimination do not mandate absolute parity between residents and non-residents.
- The question whether the income is taxable or not, is a question which is to be answered at a later stage. In order for an entity to be subjected to an assessment, the existence of PE is not essential.
- Withholding liability is provisional in nature. The deduction of tax at source being a measure to safeguard interest of the Revenue, the payee shall be subjected to scrutiny when it is assessed. That scrutiny cannot be done at the stage when the tax is to be deducted by the payer.

Contention of the Taxpayer

- The payments to group companies, resident of USA and Japan are subjected to non-discrimination clause under respective treaties. Relying upon observations of Bombay High Court in the case of ***Herbal life*** (supra), the taxpayer argued that the 'other sum' chargeable to tax shall be disallowed if paid to non-residents without withholding taxes at source but shall be allowed if paid to residents without deduction of taxes, is a form of discrimination discouraged under the India-Japan and India-USA treaties.
- Provisions of section 195 requiring deduction of TDS are not determinative on the issue of discrimination.
- The taxpayer relied upon Supreme Court ruling in the case of ***GE India Technology Cen. P. Ltd.*** **v.** ***CIT***[4] to contend that until and unless the issue of chargeability is not decided, the liability to deduct tax does not exist.
- With respect to payment to residents of Singapore and Thailand, onus is on the department to establish that payee has PE in India. Since the payees, resident of Singapore and Thailand, do not have PE in India, the income cannot be considered as 'chargeable to tax' in India and hence, no withholding liability shall arise.

Ruling of the High Court

- The division bench of Delhi High Court pronounced divergent judgment in 2017 with one member in favour and another member against and referred the matter to the Third Judge.
- The Third Judge observed that the section 40(a)(ia) was introduced vide Finance Act, 2004, to disallow the 'specified' sum paid to resident without deduction of taxes at source, however, it did not bring payments made towards purchases to resident vendors within its net. Hence, even after introduction of section 40(a)(ia), the discrimination continued. Since provisions of non-

[4] [2010] 327 ITR 456 (SC)

discrimination article under treaties are more beneficial, the disallowance was rightly deleted by the ITAT.

- Since the receipt from provision of services and payment for purchase consideration are two different transactions, the transfer pricing norms under Article 9 as made applicable to the consideration received from group companies for provision of services are not relevant for determining applicability of non-discrimination article for deduction of purchase consideration.
- The Third Judge relied upon ITAT observations to the effect that other group companies, resident of Thailand and Singapore, do not have PE in India and hence, applying India-Singapore and India-Thailand treaties, no income is chargeable to tax. Accordingly, it was held that the taxpayer is not obliged to deduct taxes at source from the payments to residents of Thailand and Singapore.

Dhruva Comments

- This is a welcome ruling of Delhi High Court clarifying applicability of non-discrimination clause under the treaty in respect of disallowance under section 40(a)(i) of the Act.
- The Judgment reaffirms the proposition that the withholding liability shall arise only in the cases where the income is chargeable to tax in India and for determination of '*chargeability*', the provisions of domestic tax laws as well as treaty provisions are relevant.
- The ratio laid down by the judgment can be applied to payments to non-residents subjected to treaties having similar non-discrimination clause regarding deductibility of expenditure, such as covered under key Indian treaties with Netherlands, Luxembourg, Germany, Switzerland, etc. Pertinent to note that the treaties with Singapore and Mauritius do not have similar non-discrimination clause with respect to deductibility of expenditure.
- The Third Judge noted that the discrimination regarding deductibility of 'other sum chargeable to tax' was removed by Finance Act 2014 w.e.f. from 1 April 2015, when the ambit of disallowance was enlarged by bringing any sum payable to a resident within the four corners of clause (ia) of Section 40(a). However, the judgment does not specifically deal with the issue whether 100% disallowance on payment to non-residents under section 40(a)(i) can be regarded as discriminatory as compared with 30% disallowance on payment to residents under section 40(a)(ia).
- The principles laid down by the High Court can be relied upon in the cases involving disallowance under Section 40(a)(ib) for failure to deduct equalization levy on payments to non-residents.

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Hope you will find this alert useful. For any queries in relation to this tax alert, you can reach out to Dhruva Advisors LLP.

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