Bombay Tax Tribunal:
Non-discrimination Clause Used to Allow Deductions For Income Paid to Non-resident

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The Income Tax Appellate Tribunal (the "Tribunal") at Mumbai has, in the case of Central Bank of India[1], held that the payments made by the Central Bank of India (the "Bank") to Visa and Master Card ("V&M"), both US resident companies, cannot be disallowed under Section 40(a)(i) of the Income Tax Act, 1961 (the "Act") for not having deducted appropriate taxes at source. The Tribunal was of the opinion that the provision under Section 40(a)(i) of the Act, was not in conformity with the non-discrimination clause under the Double Taxation Avoidance Agreement between India and the US (the "DTAA").

Facts

The credit cards issued by the bank were affliated to V&M, the two US international agencies who were operating through highly advanced computer system. The system transferred data to and from the point where a credit card is issued in a shop or establishment to the central processing centre which may be based outside the India. The processing centers communicated with the bank to confrm the validity of card, available credit etc. V&M also provided customized software and hardware to the bank to facilitate the process. V&M charged the bank for the various services provided. The amount charged depended upon the volume of transactions. The Bank made all these payments without withholding any tax at source in India.

Subsequently, when the Bank claimed the payments made to V&M as deductions in computing its taxable income, the tax authorities applied Section 40(a)(i) of the Act (as it existed prior to its amendment in 2004[2]). This provision disallows any expenditure (payments made to non-residents) as deductions if appropriate tax is not deducted at source at the time of making the payment to the non-resident. Accordingly, the tax authorities disallowed these deductions contending that tax was not deducted at source on the payments.

The Bank contended that the payments made to V&M were not taxable in India as V&M did not have a permanent establishment in India. However, the tax authorities noted that V&M had acquired leased telephone lines in India and had also installed machinery and computers for their network in India. Accordingly, the tax authorities held that V&M would be reckoned as having a permanent establishment in India and, therefore, the payments made to V&M would be taxable in India.

The Bank contended that the payments made to V&M could not be disallowed as deductions from its taxable income as this violated the non-discrimination clause of the DTAA.

The litigation eventually reached the Tribunal as the Bank appealed against the tax authorities' decision.

Issues

The pertinent issue was regarding the allowability of the claim of deduction on account of the payments made to the non residents and the consequent applicability of Article 26[3] of the DTAA.

Parties' Contentions

The Bank contended that the payments made to V&M could not be disallowed as deductions from its taxable income as this violated the non-discrimination clause of the DTAA. This is because there was no similar provision in the Act for disallowing payments made to residents if tax was not deducted at source at the time of making the payment. Accordingly, the payments made to a non-resident cannot be disallowed merely because tax was not deducted at source at the time of making the payment. To support its contentions, the Bank relied on an earlier decision of the Delhi bench of the Tribunal wherein a similar ruling was passed.[4]

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Decision of the Tribunal

The Tribunal ruled that such payments could not be disallowed considering that, there was no similar provision that disallowed similar payments to residents without deducting tax at source. It held that Article 26(3) of DTAA seeks to provide against such discrimination and that deduction should be allowed on the same condition as if the payment is made to a resident. Thus this clause in the DTAA neutralizes the rigour of the provisions of Section 40(a)(i). By virtue of the provisions of Section 90(2) of the Act, the law which is more benefcial to the assessee to whom the DTAA applies should be followed and, therefore, the tax authority cannot seek to disallow the claim of the Bank even on the assumption that the sum in question is chargeable to tax in India. Further, the Tribunal also noted there were certain exceptions provided to the applicability of Article 26(3) and ruled that none of these exceptions were applicable to the Bank's case considering that the Bank and both, V&M, were not related entities.

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Majmudar & Co.'s Comments

This is an important decision from the perspective of interpreting the non-discrimination clause as well as the provision providing for disallowance of expenses in the absence of deduction of tax at source.

Having said that, a few words of caution are pertinent here:

(a) The Act was amended in 2004 and provisions were introduced for disallowing similar payments made to residents. Therefore, to the extent similar provisions exist for residents; this ruling will not have any direct implication.

(b) Non-discrimination clauses may have certain exceptions which need to be carefully assessed in the background of the concerned tax treaty.

(c) The tax authorities are unlikely to give the beneft of non-discrimination clauses during assessment proceedings. Therefore, litigation on this point cannot be overruled despite the presence of this ruling. o

1 Central Bank of India v. DCIT, Income Tax Appeal No.4155/M/2003, (Order dated 24 September 2010).

2 The said provisions as applicable in the relevant year read as under "40(a)(i) any interest (not being interest on a loan issued for public subscription before 1st day of April 1938), royalty, fees for technical services or other sum chargeable under this Act which is payable outside India on which tax had not been paid or deducted under Chapter XVII B.

Provided that where in respect of any such sum tax had been paid or deducted under Chapter XVIIB in any subsequent year the sums shall be allowed as a deduction in computing the income of the previous year in which such tax had been paid or deducted.

Explanation - for the purpose of this sub clause (A) royalty shall have the same meaning as in Explanation 1 to clause (vi) of sub section (1) of section 9. (B) Fees for technical services shall have the same meaning as in Explanation-2 to clause (vii) of sub section (1) of section 9.

3 Article 26(3) of the DTAA:- Where the provisions of paragraph 1of Article 19 (Associated Enterprises), paragraph- 7 of Article 11 (interest) of paragraph- 8 of Article 12 (royalties and fees for included service) apply, interest, royalties and other disbursements paid by a resident to a Contracting State to resident of other Contracting State shall for the purposes of determining taxable proft of the frst mentioned resident, be deductible under the same conditions as if they had been paid to a resident of frst mentioned state."

4 Harbalife International India Pvt. Ltd. v. ACIT [2006] 103 TTJ 78 (Del)

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