Executive summary

This Tax Alert summarizes a recent ruling[1] of the Delhi Income Tax Appellate Tribunal (Delhi Tribunal) in the case of Mitsubishi Corporation India Pvt. Ltd. (Taxpayer) on application of the non-discrimination clause of the India-Japan Double Taxation Avoidance Agreement (Japan DTAA). The Delhi Tribunal noted that payments made to residents, without deduction of tax at source, were deductible if the recipient included the same in its Return of Income (ROI), paid tax on it etc. On a similar analogy, the Delhi Tribunal, applying the deduction neutrality non-discrimination clause of the Japan DTAA, held that the payments made by the Taxpayer to nonresidents (NRs), without deduction of tax at source, cannot be disallowed.

Background and facts

► Under the Indian Tax Laws (ITL), specific payments to residents and all payments to NRs which bear income character require withholding tax at source.

► As part of adverse consequences of non-compliance with withholding tax provisions, payments without deduction of tax at source are disallowed while computing income of the payer.

► The ITL provides for relief from such a consequence if a resident payee furnishes its ROI after including such income, pays taxes due on such income and furnishes a certificate from a CA of the payee. However, no comparable relief is available where the payment is made to an NR.

► Many Indian DTAs provide for a non-discrimination article that includes a deduction neutrality non-discrimination clause. One such DTAA is the 1989 Japan DTAA.

► The deduction neutrality clause in the non-discrimination article provides that, while computing taxable income of an Indian enterprise, payments made by it to a resident of Japan would be deductible under the same conditions as if they had been paid to an Indian resident.

► The Taxpayer is a wholly-owned subsidiary of a Japanese company engaged in general trading business and links buyers and sellers for a variety of products.

► During tax year 2006-07, the Taxpayer made payments to various NR group entities, which included Japanese entities as well, for purchase of goods. These payments were made without deduction of tax at source.

► However, in cases where the recipient entity undisputedly had a permanent establishment (PE) in India, the entity had filed the ROI, including income received from the Taxpayer, and had paid taxes due on such income.

► The Tax Authority disallowed payments of the Taxpayer for non-compliance with withholding tax provisions, which was upheld by the Dispute Resolution Panel (DRP). The aggrieved Taxpayer appealed to the Delhi Tribunal.

Delhi Tribunal’s ruling

► The purchase payments made by the Taxpayer can be segregated into three broad categories:

► Category A: where the Tax Authority’s claim of recipients having a PE in India is negated by the judicial authorities i.e., the recipients had no PE in India.

► Category B: where there was no material on record with the Tax Authority that recipients had a PE and the same was also not in dispute before any judicial authority.

► Category C: where the recipient entity had a PE in India.

► Category A: The payments did not give rise to any income chargeable to tax in India in the absence of a PE. Since the payments were not taxable, there was no liability to withhold taxes and, accordingly, the payments cannot be disallowed.

► Category B: The onus to show that a foreign company has a PE in India is on the Tax Authority. When such onus is not discharged by the Tax Authority, the business profits earned by these entities cannot be taxed in India. Accordingly, the Taxpayer cannot be proceeded against for not withholding taxes on payments made to such entities.

[2] Presently, 30% in case of payments to residents and 100% in case of payments to NRs.

Category C: The Taxpayer was of the view that, on application of the non-discrimination clause of the Japan DTAA, the payments would not be disallowed.

Application of the deduction neutrality clause in the non-discrimination article

Can Indian residents apply the deduction non-discrimination clause of the Japan DTAA

The Tax Authority contended that the Taxpayer, being a resident of India, is not entitled to the protection in India under the deduction non-discrimination clause of the Japan DTAA.

The coordinate bench of the Pune Tribunal, in the case of Daimler Chrysler India[^4], had held that, in order to invoke the deduction non-discrimination clause, it is not necessary for the taxpayer to be a resident or national of the other Contracting State. Mere payment to a resident of the other Contracting State would suffice to trigger deduction neutrality under the non-discrimination clause.

Though the provision impacts assessment and income determination of the Indian residents, the subject matter of treaty protection is the Japanese tax resident and there is no legal infirmity in the claim made by the Taxpayer. This is also supported by several judicial precedents[^5].

Thus, the Tax Authority is not right in contending that a resident of India is not entitled to protection in India under the deduction neutrality clause of the non-discrimination article of the Japan DTAA.

Scope of the deduction non-discrimination clause of the Japan DTAA

The deduction neutrality clause in the non-discrimination article is designed to primarily seek parity in eligibility for deduction between payments made to residents and those made to NRs.

As discussed in the UN Model Convention Commentary, the objective behind the deduction neutrality non-discrimination clause is to end a certain form of discrimination resulting from countries allowing unrestricted deduction of interest, royalty and other disbursements to a resident, which are restricted or even prohibited when the recipient is an NR.

Thus, it can be concluded that there cannot be discrimination regarding deductibility of expenses as far as payments to Japanese residents are concerned. If withholding tax is a pre-condition for deductibility of payments to NRs, it cannot be enforced unless there is a similar pre-condition on payments to residents as well, in light of the arguments discussed below.

Differentiation v discrimination

The Tax Authority contended that differentiation in treatment cannot be treated as discrimination, by relying upon the Pune Tribunal’s ruling in the case of Automated Securities Clearance Inc[^6], wherein the Pune Tribunal had held that, in order to establish discrimination, the taxpayer has to demonstrate that it has been subjected to different treatment vis-à-vis other taxpayers, which is unreasonable, arbitrary or irrelevant.

[^4]: 29 SOT 202[^5]: 118 TTJ 619[^6]: 118 TTJ 619

Herbalife International India [101 ITD 450], Asianet Communications Ltd. [38 SOT 15B], B4U International Holdings Limited [52 SOT 545], Central Bank of India [42 SOT 450], Lazard India Ltd. [41 SOT 72], Incent Tours Pvt. Ltd. [53 SOT 308], Millennium Infocom Technologies [21 SOT 152], Sandoz Pvt. Ltd. [149 ITD 507]
However, the above ruling was in the context of the India-US DTAA and cannot be automatically applied to other Indian DTAAAs. The Special Bench of the Ahmedabad Tribunal, in the case of Rajeev Sureshbhai Gajwani[7], held that even differentiation simpliciter in deductibility of payments to NRs vis-à-vis residents is sufficient to invoke the non-discrimination clause.

**Impact of tax payment by recipient foreign entity on the impugned disallowance**

The Finance Act, 2012 had relaxed the tax provision under the ITL relating to disallowance of payments made to residents, without deduction of tax at source, if the recipient filed its ROI, included the payment as its income in the ROI, paid the appropriate taxes due on such income, etc. This amendment was effective from 1 April 2013.

The Agra Tribunal, in the case of Rajeev Kumar Agarwal[8], had held that this amendment was applicable retrospectively from 1 April 2005 when the disallowance provision was introduced for resident payments based on the following reasoning:

The provision for disallowance of expenses is not a penal provision but is a kind of compensatory deduction restriction for an income going untaxed due to tax withholding lapse. Prior to the 2012 amendment, the rigors of this provision went beyond the intentions of lawmakers. Therefore, the amendment sought to cure the shortcomings and obviate the unintended hardships.

The decision of the Special Bench of the Mumbai Tribunal, in the case of Bharati Shipyard[9], had observed that an amendment of a substantive provision aimed at removing unintended consequences to make the provision workable has to be treated as retrospective in application.

Since the same payment made to a resident does not result in disallowance of expense if the resident complies with requisite conditions, it will have to be allowed as a deduction where the NR complies with the same conditions by applying the deduction neutrality non-discrimination clause.

**Comments**

Presently, the ITL does not provide for relief to the payer from disallowance of expense on payments to NRs, even though the recipient NR complies with the tax payment and certain other conditions are fulfilled.

Many Indian DTAAAs contain the non-discrimination article. However, out of such DTAAAs, only some contain the clause facilitating deduction neutrality. Illustratively, India’s DTAAAs with Finland, France, Germany, Hungary, Japan, the Netherlands and the US contain this clause.

The Delhi Tribunal, in this decision, has elucidated the various facets of availing the benefit of the deduction neutrality clause of the non-discrimination article and should be welcomed by taxpayers. Notably, the Finance Act, 2014 has restricted the disallowance on 

[7][8 ITR (Trib) 616]
[8][149 ITD 363]. Several recent decisions have upheld that the Finance Act, 2012 amendments are applicable with retrospective effect. Illustratively, a reference can be made to G. Shankar (ITA No.1832/Bang/2013), Ananda Marakala (ITA No.1584/Bang/2012), S.M. Anand (ITA No.1831/Bang/2013).
payments made to residents, without deduction of tax, to 30% of the payment. A corresponding change in respect of payments to NRs has not been made. Accordingly, in appropriate cases, this argument can be raised by taxpayers to avail of deduction parity by invoking the deduction non-discrimination clause.