

## ***Taxes paid outside India not deductible from business profits under section 37(1); Disallowable under section 40(a)(ii)***

April 10, 2017

### ***In brief***

In a recent judgement<sup>1</sup>, the Ahmedabad Bench of the Income-tax Appellate Tribunal (Tribunal) has held that deduction under section 37(1) of the Income-tax Act, 1961 (Act) shall not be available for taxes paid abroad and the same shall be disallowable under section 40(a)(ii) of the Act.

### ***In detail***

#### ***Facts of the case***

- The taxpayer<sup>1</sup> was an Indian company, engaged in the business of developing software products.
- During the year under consideration, the taxpayer had earned business income from Indonesia, Malaysia and Rwanda, from which, taxes had been withheld in the source countries. The taxpayer had claimed relief for these taxes under section 90/ 91 of the Act.
- The foreign tax credit (FTC), granted to the taxpayer by the tax officer (TO) during the assessment proceedings, was lower than the amount claimed by the taxpayer as relief. In the appeal before the Commissioner of Income-

tax (Appeals) [CIT(A)], the CIT(A) had confirmed the quantification of eligible FTC made by the TO. Further, for the remaining amount of taxes paid abroad, the CIT(A) had allowed deduction from the business profits under section 37(1) of the Act. This issue had been previously brushed aside by the TO during the assessment proceedings without any discussion thereof.

#### ***Issues before the Tribunal***

Whether deduction under section 37(1) of the Act shall be available for that portion of income-tax paid abroad, for which relief was not available under section 90/ 91 of the Act, or whether such tax shall come under the purview of the term “tax,” as mentioned in section 40(a)(ii) of the Act and

be disallowed when computing business profits.

#### ***Taxpayer’s contentions***

- The term “tax,” as mentioned in section 40(a)(ii) of the Act, has been defined in section 2(43) of the Act as “tax chargeable under the Act,” and accordingly, its connotations were confined to only such tax as was paid in India.
- In terms of Explanation 1 to section 40(a)(ii) of the Act, it was clear that the bar placed in section 40(a)(ii) of the Act on the deduction of taxes from business profits was confined only to such income-tax paid abroad, for which relief was available under section 90/ 91 of the Act.

<sup>1</sup> [2017] 80 taxmann.com 6 (Ahmedabad –Tribunal)/ ITA No. 508/Ahd/2016

- The taxes paid abroad were inherently in the nature of expenses incurred for business and as such, were allowable as deduction under section 37(1) of the Act.
- Reliance was placed on the decision of the Bombay High Court in the case of Reliance Infrastructure Limited,<sup>2</sup> the decision of the coordinate bench in the case of Mastek Limited<sup>3</sup> and other similar rulings.

### Revenue's contentions

No reason to assume that the restriction placed in section 40(a)(ii) of the Act was confined to taxes paid in India and the taxpayer's contentions were hyper technical in nature.

### Tribunal's ruling

- In addressing the question related to the impact of section 2(43) of the Act on the connotations of the term "tax" given in section 40(a)(ii) of the Act, the Tribunal referred to the guidance provided in earlier decisions<sup>4</sup>, wherein it was held that the word "tax" given in section 40(a)(ii) of the Act was used in conjunction with the words "any rate or tax" and had been further qualified as tax levied on or assessed at a proportion of business profits. Further, it was held that if the term "tax" given in section 40(a)(ii) of the Act was to be assigned the meaning given to it in section 2(43) of the Act, the word "any" used before it would become otiose and the further qualification as to the nature of levy would also become meaningless. Thus, the term "tax" given

in section 40(a)(ii) of the Act referred to any kind of tax levied on or assessed at a proportion of business profits.

- The Supreme Court<sup>5</sup> noted that all what was mentioned in section 40(a)(ii) of the Act was that it must be a tax levied on business profits and there was no indication that such profits should have been computed in accordance with the provisions of the Act.
- The Tribunal also took note of a decision in the case of Tata Sons<sup>6</sup>, wherein it was held that the meaning of the expression "tax" should have been understood in the context of section 40(a)(ii) of the Act and the statutory definition given in section 2(43) of the Act could not be applied everywhere on a "one size fits all" basis. Accordingly, it was held that no deduction under section 37(1) of the Act shall be allowed for income tax paid abroad.
- The judicial precedents relied upon by the taxpayer were distinguished by the Tribunal as follows:
  - Reliance Infrastructure Limited<sup>2</sup> was based on peculiar facts and it was not urged by the Revenue that the context in which the term "tax" had been used in section 40(a)(ii) of the Act would require it to mean taxes paid anywhere in the world and not only taxes payable/ paid under the Act.
  - The case of Mastek Limited<sup>3</sup> was a *per incuriam* decision because

it had been rendered without taking into account earlier decisions on similar issues. Thus, the ruling in the case of Mastek Limited was not considered as binding on the Tribunal.

- Further, the Tribunal stated that the Explanation to a section does not extend the scope of a section but rather explains the said scope. If something was covered by the Explanation, it could not be said that it was not covered by the main provision. Accordingly, it was held by the Tribunal that if taxes, for which relief under section 90/91 was available, was covered by the Explanation 1 to section 40(a)(ii) of the Act, they were covered by the scope of section 40(a)(ii) of the Act also.

### The takeaways

This is an important decision for resident taxpayers paying taxes outside India; especially as it discusses and considers the differing judicial precedents available on the issue of whether deduction under section 37(1) of the Act shall be available for that portion of income-tax paid abroad, for which relief is not available under section 90/91 of the Act, or whether such tax shall come under the purview of the term "tax," as mentioned in section 40(a)(ii) of the Act and be disallowed while computing business profits.

### Let's talk

For a deeper discussion of how this issue might affect your business, please contact your local PwC advisor

<sup>2</sup> (2017) 390 ITR 271 (Bom)  
<sup>3</sup> (2013) 36 taxmann.com 384 (Ahmedabad – Trib.)

<sup>4</sup> Lubrizol India Limited (1991) 187 ITR 25 (Bom) &

<sup>5</sup> Smithkline & French India Limited (1996) 219 ITR 581 (SC)  
<sup>6</sup> (1991) 9 ITR (Trib) 154 (Bom)

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