FTC allowed on 'income embedded in gross receipts', computed having regard to taxpayer's distinctive facts

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In brief

In a recent decision[1], the Ahmedabad Income-tax Appellate Tribunal (Tribunal) held that foreign tax credit (FTC) had to be allowed on the basis of 'income embedded in the gross receipts', and not on basis of the 'gross receipts' themselves. For computing the 'income embedded in the gross receipts', it held that where the taxpayer had furnished reasonable computation of foreign sourced income, there was no need to compute the income by allocating overall expenses in the proportion of turnover.

In detail

Facts

- The taxpayer was a wholly owned subsidiary of a US based company, which was engaged in the business of software development.
- During the relevant previous year, the taxpayer did not have taxable income under the normal provisions of the Income-tax Act, 1961 (the Act), and paid taxes under the minimum alternate tax (MAT) provisions.
- During the assessment proceedings, the tax officer (TO) noted that the taxpayer had received income from a Singapore entity, in the nature of margin money on the sale of a software license, where tax withholding of INR 5,41,029 was done in Singapore.
- The taxpayer had also received income from an Indonesian entity on sale of incremental software license and undertaking an annual maintenance contract, where tax of INR 5,71,878 was withheld in Indonesia. Aggregating this, the taxpayer had claimed FTC amounting to INR 11,12,907, in respect of taxes withheld in Singapore and Indonesia.
- The TO did not approve the taxpayer's claim and restricted the amount of FTC to INR 86,571. The TO was of the view that the FTC was to be allowed only to the extent that the corresponding income had suffered tax in India. In respect of the taxpayer's case, the TO was of the view that the extent to which income had suffered tax in India had to be computed as follows:

$$\frac{MAT * Foreign\ Receipts}{Overall\ Turnover}$$

- On the other hand, the taxpayer contended that the 'gross receipts' were relevant for the purpose of computing the tax credit. The relevant article[2] of the tax treaty states that tax credit would be available for "profit or income," which had been subjected to tax in both the countries. As per the taxpayer, the entire receipt should have been considered as doubly taxed, looking to the intention and scheme of the tax treaties.

[1] ITA No.623/ Ahd/ 2015
[2] Article 23 of the India-Indonesia tax treaty and Article 25 of the India-Singapore tax treaty

- Thus, the entire foreign tax should have been eligible as FTC in India.
- The taxpayer appealed before the Commissioner of Income-tax (Appeals), who upheld the TO's order. Aggrieved, the taxpayer filed an appeal before the Tribunal.

Issue before the Tribunal

- What was the manner of computing 'income', which was treated as taxed in both the countries?
- What was the manner of computing the eligible FTC on such income?

Tribunal's ruling

- The Tribunal observed that the India-Singapore tax treaty as well as the India-Indonesia tax treaty provide for FTC not to exceed the income tax attributable to the 'income', which was taxed in the other state. However, there was limited guidance on the manner of computing such 'income'.
- Placing reliance on the Commentary to OECD Model Convention, the Tribunal noted that the expression 'income', essentially implied 'income embedded in the gross receipts', and not the 'gross receipts' themselves. Thus, it stated that the taxpayer's approach of considering 'gross receipts' as income was incorrect.
- However, the Tribunal acknowledged distinctive facts of the taxpayer's case, as follows:
  - The taxpayer's main business was conducted in India, and only three isolated transactions had resulted into income from Singapore and Indonesia.
  - The first two transactions were for the release of margin money and addition of users, which did not require any activity on the taxpayer's part, and thus resulted in passive earnings. No part of the costs incurred in India could be allocated to such earnings from Singapore and Indonesia.
  - With respect to the third transaction, being earnings from maintenance contract, the taxpayer had allocated the costs on a proportionate basis and no defects were pointed out in such allocation.
- In view of the above facts, the Tribunal stated that the taxpayer had furnished a reasonable computation of income, and thus rejected the TO's stand of allocating all the costs borne by the taxpayer, in proportion of turnover, to the earnings from Indonesia and Singapore.
- The Tribunal further observed that the concept of averaging of costs to the overall revenues could only come into play when the income embedded in the gross receipt could not be worked out on any other reasonable basis. The taxpayer, in this case, had furnished computation of income arising from foreign receipts to the satisfaction of the Tribunal, and thus, the averaging of cost to foreign income was not required.
- The Tribunal remarked that this ruling should not be used as a general proposition that only the marginal or incremental costs incurred in respect of the foreign income were to be taken into account, and overheads were not to be allocated.
- The Tribunal noted that the FTC had to be computed on a proportionate basis, not exceeding tax attributable to the income which may be taxed doubly. Given that the taxpayer had paid taxes on the book profits, the Tribunal computed the FTC by apportioning the actual tax paid under MAT provisions in the ratio of double taxed profit to the overall profits, viz.,

$$\frac{MAT * Foreign\ (net)\ income}{Total\ Book\ Profits}$$

- Using this formula, the Tribunal worked out the FTC to be INR 9,47,344.

The takeaways

- This is a welcome ruling of the Tribunal providing guidance on the manner of computation of FTC in cases where tax is paid under the MAT provisions.
- The ruling also brings clarity that the double-taxed income, to be considered as 'income embedded in the gross receipt', i.e., gross receipts *minus* eligible expenses. The concept of averaging of costs on the basis of overall revenues is to be applied only when the doubly-taxed "income" element cannot be worked out on a reasonable basis.
- While the FTC rules[3] do not provide clarity on the issue dealt herein, this ruling may be relied upon by the taxpayers facing similar instances.

Let's talk

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

[3] Notification No. 54/ 2016, dated 27 June, 2016

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