Domestic law restrictions on allowability of expenses not applicable to PE absent specific provision in treaty

October 16, 2018

In brief

In a recent decision,[1] the Delhi bench of the Income-tax Appellate Tribunal (Tribunal) observed that the phraseology used in Article 7(3) of the India-Mauritius Double Taxation Avoidance Agreement (tax treaty) provides for deduction of expenses incurred for the purpose of business of the permanent establishment (PE) without any restrictions on applying the limitation of domestic tax law. In the absence of such restrictions, the limitation under the Income-tax Act, 1961 (Act) could not be imported under the said Article of the tax treaty.

In detail

Facts

- The taxpayer a Mauritius tax resident was engaged in business development and promotion in the energy sector in India for its parent company.
- The taxpayer constituted a PE in terms of Article 5 of the India-Mauritius tax treaty, and accordingly, offered its income to tax on net basis.
- During assessment year (AY) 1998-1999, the taxpayer had incurred certain expenses relating to operating contract, employee salaries and travel and entertainment.
- The tax officer (TO) noted that appropriate documentary evidences (i.e. vouchers and bills of expenditure for travel cost, details of tax withheld on salaries paid to employees, etc.) were not produced for the said expenses. Further, the taxpayer did not withhold any taxes under section 195 of the Act. Accordingly, the TO disallowed the aforesaid expenditure.
- Before the first appellate authority, the taxpayer contended that employee salaries were not taxable in India on account of the short stay exemption available to them under Article 15 of the India-US tax treaty.
- It was further submitted that Article 7(3) of the India-Mauritius tax treaty, is differently worded as compared to tax treaties with other countries, which implement additional restriction on deduction of expenses and are subject to the limitation of tax law of that state (i.e. domestic law of India). Under the India-Mauritius tax treaty, there was no such restriction for the claim of expenses under Article 7(3). To support its contention the taxpayer relied on the State Bank of Mauritius Limited[2] judgment.
- It was also contended that sufficient details (such as ledger copies, names of employees, details of Indian project, etc.) were submitted to the TO in support of the expenses. Once these details were

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[1] ITA No. 1388/ DEL./ 2012

[2] JCIT *v.* State Bank of Mauritius Limited 2009 TIOL 712

submitted, the onus was on the TO to prove that the details were insufficient/ erroneous, without which, a disallowance could not be made.

- The first appellate authority upheld the taxpayer's contentions.

Issue before the Tribunal

Whether the allowability of the said expenses, especially in light of the taxpayer's contention that in absence of any restrictive clause in Article 7 of the India-Mauritius tax treaty, invoking the provisions of section 40(a)(i) was unwarranted?

Revenue's contention

The Revenue contended that since the taxpayer did not conduct any business of its own, the question of allowing any expenditure while computing the income of the PE did not arise.

Tribunal's decision

- Relying on the decision of Mumbai bench of the Tribunal in the case of State Bank of Mauritius[3], the Tribunal held that –
  - Para 3 of Article 7 of India-Mauritius tax treaty provides for the determination of profits of a PE by allowing the deduction of expenses incurred for the business of the PE, including executive and general administrative expenses so incurred in which the PE was situated.
  - Accordingly, all the expenses incurred for the purpose of the business of the PE were to be allowed. There was no restriction on the allowability of such expenses subject to any limitation of the tax laws of the contracting state (India).
  - The phraseology used in Article 7 (3) is different from other treaties, for instance, Article 7(3) of the India-US tax treaty provides that the deduction of expenses incurred for the purpose of business of the PE would be in accordance with provisions subject to the limitation of the tax laws of that State. A similar phraseology has been used in the India-UAE tax treaty after the protocol.
  - Once no such restriction has been provided in a tax treaty for applying the limitation of the domestic tax laws, such limitation under the Indian Income-tax Act cannot be imported in such an Article.
  - If the expenditure was incurred, it had to be allowed while computing the profit and loss of the PE in full and without any restriction of deductibility, as per the provision of the Act.

The takeaways

- Constitution of PE in the source state is a highly litigious issue. When a non-resident taxpayer believes that it does not have a PE in India, it is likely that it will not undertake any compliance with the domestic tax law requirement of the source state.
- However, taxpayers often face challenges when tax authorities counter their "no PE" stand and invoke taxability on very high profit margins by disallowing expenses incurred by the alleged PE, owing to non-compliance with domestic tax law requirements.
- The language of clauses, such as para 3 of the Article 7 of the India-Mauritius tax treaty could come to the rescue of the non-resident taxpayer in protecting their basic right to restrict their tax liability to net income, when PE allegations are made by the tax authorities of the source state.
- In this decision, the Tribunal has confirmed that in the absence of any restrictions on the allowability of expenses in Article 7(3) of the India-Mauritius tax treaty, the provisions of section 40(a)(i) of the Act cannot be invoked. In other words, the tax treaty should contain a specific requirement to comply with the local laws of the source state for its invocation.

Let's talk

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

[3] ITA No. 2254/ MUM /2005

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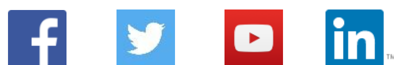

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