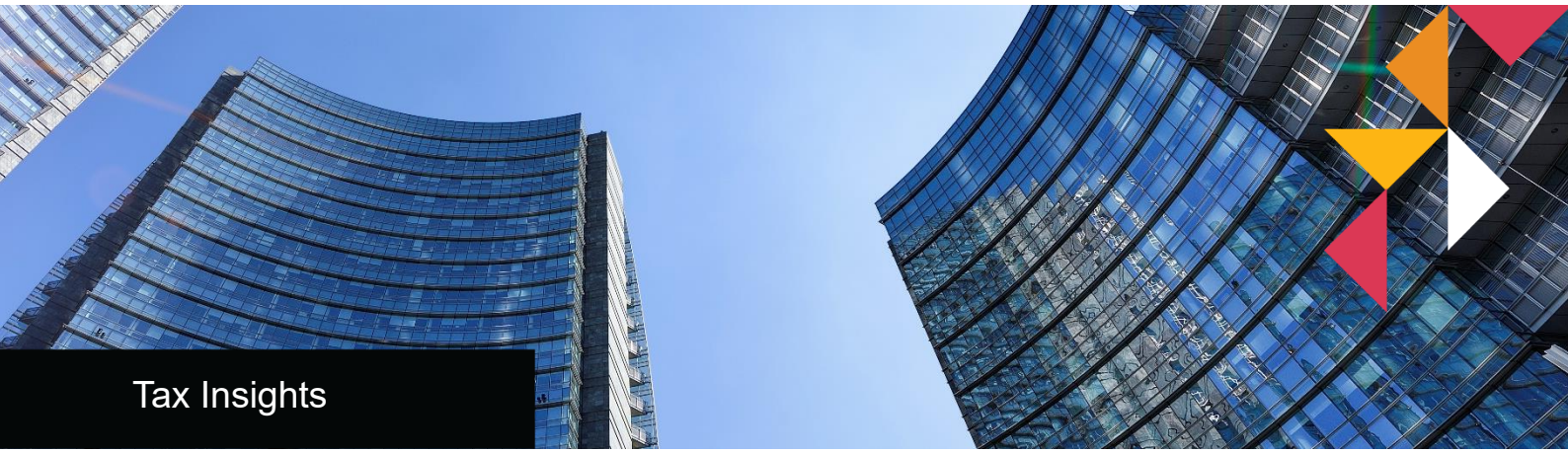

Tax Insights

26 February 2024

No disallowance is warranted under section 40(a)(i) of the Act on payment to non-residents (having PE in India) towards purchase of goods considering non-discrimination clause in India-Japan and India-USA DTAAs – Delhi High Court

In brief

The tax officer (TO) disallowed the payment made to the non-resident associated enterprises (AEs) based in Japan and the USA towards material purchase under section 40(a)(i) of the Income-tax Act, 1961 (the Act), concluding that the taxpayer was liable to deduct tax from such payments. The Delhi High Court[1] opined that the provisions of disallowance of payment to non-residents are not at par *vis-à-vis* payment to residents. Hence, the taxpayer was justified in invoking the provisions of the non-discrimination clause in the Japan and USA Double Taxation Avoidance Agreement (DTAA). Consequently, the disallowance under section 40(a)(i) of the Act is not warranted.

In detail

Facts

- During financial year (FY) 2005-06 [relevant to assessment year (AY) 2006-07], the taxpayer[2], an Indian company, made remittances to its non-resident AEs for the purchase of goods without deducting tax.
- Since one of the Japanese AE had a liaison office in India, which was treated as its permanent establishment (PE), the TO argued that all non-resident entities have PE in India. Consequently, the taxpayer was liable to deduct tax under section 195 of the Act on all payments made to a non-resident, and thus, disallowed the entire amount of remittance under section 40(a)(i) of the Act. This addition was upheld by the Dispute Resolution Panel (DRP).
- On appeal, the Income-tax Appellate Tribunal (Tribunal) concluded that the taxpayer was not liable to deduct tax from the remittances made to the AEs based in Japan and the USA considering the non-discrimination clause in the respective DTAAs.

1 ITA No. 180/2014

2 The decision includes other issues such as the non-applicability of the provisions of section 195 of the Act in case the income is not taxable in India. However, in this Tax Insights we have discussed only the critical issue of disallowance under section 40(a)(i) of the Act considering the non-discrimination clause present in the relevant DTAAs.

Revenue's contentions

- The TO submitted that, *via* Finance Act, 2004, clause (ia) was introduced in section 40(a) of the Act to bring parity between the disallowance of certain payments made to residents *vis-à-vis* non-residents for the non-deduction of tax. Therefore, the non-discrimination clause of the relevant DTAAs were not applicable in this case.

- Additionally, the non-discrimination clause in the DTAAs under consideration do not extend the benefit of non-discrimination where the adjustments were made considering Article 9 of both the DTAAs. In the given case, a transfer pricing (TP) adjustment was made with respect to the payment made to the AEs for the services availed. Thus, Article 9 is applicable in the case of AEs located in Japan and the USA. Accordingly, the non-discrimination clause cannot be invoked in such a case.

Taxpayer's contentions

- The taxpayer submitted that it had two separate streams of payment towards services and material purchased, which cannot be considered as a composite transaction for the purpose of deduction of tax. While the purchase transaction was made subject to the disallowance under section 40(a)(i) the Act, the service transaction was subjected to the TP adjustment. Therefore, the TP adjustment made to one stream of payment considering Article 9 of the DTAA should not restrict the taxpayer from taking the benefit of the non-discrimination clause for another stream of payment.

- Additionally, the argument about discriminative tax treatment will not affect merely because the transaction was entered into with the AEs being subject to evaluation under TP principles.

- The taxpayer relied on the decision delivered by the co-ordinate bench of the court in the case of Herbal Life International (P.) Limited[3], which lays down the following principles –
    a. The benefit of the non-discrimination clause cannot be denied where the provisions of Article 9 for the purpose of making TP adjustments are not invoked with respect to that specific deduction.
    b. The resident may invoke the provisions of the non-discrimination clause as far as the payment is being made to a non-resident.

    This decision stands accepted by the department as no further appeal before the Supreme Court has been preferred in this case.

High Court's decision

- The taxpayer was correct in invoking the non-discrimination clause of the respective DTAAs. Although clause (ia) was introduced in section 40(a) of the Act to remove the disparity between the payment made to the residents *vis-à-vis* non-residents, clause (ia) requires the disallowance of only certain payments on account of the non-deduction of tax. The same does not include payments towards purchases, whereas clause (i) covers all payments made to the non-residents. To this extent, the disparity still prevails, and thus, the taxpayer is right in their approach of seeking the benefit of the non-discrimination clause of the DTAAs.

- The TP adjustment in the given case was made with respect to the service payments made with the AEs, which is not the subject matter of the disallowance under section 40(a)(i) of the Act. Thus, the provisions of Article 9 of the DTAAs does not have any implication in the given case.

- Thus, the payment made by the taxpayer to the AEs towards the purchase of goods is not subject to disallowance under section 40(a)(i) of the Act on account of the non-discrimination clause in the respective DTAAs.

The takeaways

The decision adjudicates the availability of the benefit of the non-discrimination clause in the DTAA, where disparity was found between the provisions of the Act as applicable to a resident *vis-à-vis* non-resident. While the disparity in the types of payments which are subjected to disallowance under section 40(a)(i) of the Act was removed by the Finance Act, 2014, the disparity in the quantum of disallowance (i.e. 100% in the case of non-residents compared to 30% in the case of residents) persists. Given this, one can evaluate the applicability of

[3] CIT *v.* Herbalife International (P.) Limited [2016] 69 taxmann.com 205 (Delhi)

the aforesaid decision to the extant provisions of section 40(a)(i) of the Act. Additionally, the principles laid down herein may be relevant with respect to the other provisions of the Act (e.g. section 94B of the Act, which restricts interest payments made to non-resident AEs, whereas no such restriction prevails for the interest payments made to resident AEs).

About PwC

At PwC, our purpose is to build trust in society and solve important problems. We're a network of firms in 151 countries with over 360,000 people who are committed to delivering quality in assurance, advisory and tax services. Find out more and tell us what matters to you by visiting us at www.pwc.com.

PwC refers to the PwC network and/or one or more of its member firms, each of which is a separate legal entity. Please see www.pwc.com/structure for further details.

Follow us on

Facebook, LinkedIn, Twitter and YouTube.