In view of the non-discrimination clause under the India-Japan tax treaty, no disallowance under Section 40(a)(i) is to be made in the hands of deductor if the non-resident has considered payments as income, paid taxes on the same, and filed the return of income.

6 November 2014

Background

Recently, the Delhi Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Mitsubishi Corporation India Pvt. Ltd1 (the taxpayer) held that no disallowance under Section 40(a)(i) of the Income-tax Act, 1961 (the Act) shall be made if payments are taken into account by the non-resident recipient in its computation of income, taxes on such income are paid and income tax return has been filed by such recipient, in view of non-discrimination clause in the India-Japan tax treaty (the tax treaty).

Further, the Tribunal observed that different tax treatment to the foreign enterprise per se is enough to invoke the non-discrimination clause in the tax treaty.

Facts of the case

1. The taxpayer is a subsidiary company of Mitsubishi Corporation-Japan (MCJ) in India. MCJ also has a Liaison Office (LO) in India. MCJ operates worldwide through its small business segment units called divisions and the LO.

2. During the Assessment Year (AY) 2007-08, the taxpayer made payments to MCJ for purchase of goods. Even after the incorporation of the taxpayer in India, MCJ continues to operate through LO and looks after the interests of MCJ divisions.

3. The Assessing Officer (AO) held that since MCJ had a Permanent Establishment (PE) in India, the taxpayer was required to deduct tax from the payments made to MCJ. Since, the taxpayer had failed to deduct tax at source under Section 195 of the Act, the payments were disallowed under Section 40(a)(i) of the Act.

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1 Mitsubishi Corporation India Pvt. Ltd v. DCIT (I.T.A. No.: 5042/Del/11) – Taxsutra.com
Relying on the decision in the case of Herbalife India Pvt Ltd\(^2\), the taxpayer contended that Section 40(a)(i) of the Act is discriminatory in character as no such disallowance was required to be made if the payments for purchases are made to a resident taxpayer\(^3\).

However, relying on the decision in the case of Automated Securities Clearance Inc\(^4\), the AO rejected the contention of the taxpayer. The AO held that neither such disallowance constituted discrimination, nor was it open to a resident taxpayer to invoke provisions of the tax treaty. The AO observed that the taxpayer was resident in India and was not eligible to claim the tax treaty benefits.

The Dispute Resolution Panel (DRP) upheld the order of the AO.

**Tribunal’s ruling**

The Tribunal was in agreement with the views expressed in the Delhi High Court’s decision in the case of DaimlerChrysler India Pvt Ltd\(^5\) where it was held that it is not necessary that the taxpayer, in whose case this non-discrimination is invoked, should be resident of, or even national of, the other contracting state.

The Tribunal observed that the issue of non-discrimination, seeking deduction parity, was covered in favour of the taxpayer in its own case in the preceding AY where the Tribunal on the grounds of non-discrimination deleted the disallowance of payment for purchases under Section 40(a)(i) of the Act.

There was no legal infirmity in the tax treaty protection canvassed by the taxpayer. There was a series of decisions\(^6\) on this issue where it was held that the tax treaty protection against nondiscrimination, to ensure deduction parity, can be extended in the assessments of the domestic enterprise claiming the deduction.

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\(^{2}\) Herbalife International India Private limited v. ACIT [2006] 101 ITD 450 (Del)
\(^{3}\) Under Section 40(a)(ia) of the Act
\(^{4}\) Automated Securities Clearance Inc v. ITO [2008] 118 TTJ 619 (Pune)
\(^{5}\) DaimlerChrysler India Pvt Ltd v. DCIT [2009] 29 SOT 202 (Pune)

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**Analysis of non-discrimination clause under the tax treaty**

- Article 24(3) of the tax treaty is similar to the first limb of Article 24(4) of the UN Model or OECD Model convention. Scope of the OECD Model Convention Commentary which is reproduced in the UN Model Convention Commentary provides that:

> “73. This paragraph is designed to end a particular form of discrimination resulting from the fact that in certain countries the deduction of interest, royalties and other disbursements allowed without restriction when the recipient is resident, is restricted or even prohibited when he is a non-resident.”

Relying on the above, the Tribunal agreed with the scope of the deduction neutrality clause in non-discrimination provision under the tax treaty.

- If appropriate tax withholding by the person making the payment is a *sine qua non*\(^7\) for business deduction so far as payments to non-residents are concerned, unless there is a similar pre-condition for deductibility of related expenses to the payments to residents as well, the disabling provision cannot be enforced in respect to payments made to non-residents either.

- The decision in the case of Automated Securities Clearance Inc was treaty specific in the context of India-USA tax treaty and did not automatically apply to the other tax treaties entered into by India.

- The Special Bench Tribunal, in the case of Rajeev Sureshbhai Gajwani\(^8\) has ruled that differentiation simplicitor is enough to invoke the non-discrimination clause even in the India-USA tax treaty. The Tribunal observed that these views expressed by the Special Bench were binding on the division bench.

- In view of the above, the Tribunal observed that a different treatment to the foreign enterprise *per se* is enough to invoke the non-discrimination clause in the India-Japan tax treaty. The UN and OECD Model Convention Commentaries provide deduction neutrality clause in non-discrimination provisions which is designed to primarily seek parity in eligibility for deduction between payments made to the residents and non-residents.

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\(^{7}\) Sine qua non - An indispensable and essential action, condition, or ingredient
\(^{8}\) Rajeev Sureshbhai Gajwani v. ACIT [2011] 8 ITR(T) 616 (Ahd)
When payments are taken into account by the non-resident recipient in its computation of income, taxes in respect of such income are paid and income tax return is filed by such recipient

- Relying on the decision of Rajeev Kumar Agarwal it was observed that disallowance under Section 40(a)(ia) of the Act cannot be made in respect of payments made to a resident taxpayer, even in case of non-deduction of tax at source, as long as related payments are taken into account by the recipients in computation of their income, and taxes in respect of such income are duly paid and income tax returns are duly filed under Section 139(1) of the Act.

- Section 40(a)(i) of the Act does not have an exclusion clause similar to second proviso to Section 40(a)(ia) of the Act, so far as payments made to non-residents without deduction tax is concerned. Such payments will be disallowed even if the non-resident recipient has taken into account such payments in computation of his income, has paid taxes on the same and duly filed return of income under Section 139(1) of the Act.

- It was elementary that for examining discrimination to the non-resident Japanese taxpayers, the right comparator would be a resident Indian taxpayer. As the Tribunal was examining the issue of deduction parity, they had to examine the position of deductibility in respect of a similar payment, i.e., without deduction of tax at source made to a resident Indian taxpayer.

- There was no binding judicial precedent contrary to coordinate bench decision in the case of Rajeev Kumar Agarwal, therefore, there was an element of discrimination, in terms of Article 24(3) of the tax treaty, in the deductibility of payments made to resident entities vis-a-vis non-resident Japanese entities.

- Article 24(3) of the tax treaty requires similar relaxation which is available to resident of India under the Act, in respect of the disallowance for payments made to the Japanese entities. Accordingly, the relaxation under second proviso to Section 40(a)(ia) of the Act is to be read into Section 40(a)(i) of the Act as well and it is required to be treated as retrospective in effect in the same manner as second proviso to Section 40(a)(ia) has been treated.

- Such an interpretation will lead to the deduction parity as envisaged in Article 24(3) of the tax treaty with the exceptions set out therein which were admittedly not applicable to the facts of the present case. On interpretation of the words specified in Article 24(3) of the tax treaty, it indicates that the payments made by an Indian enterprise to a resident of Japan shall be deductible in the assessment of Indian enterprise, under the same conditions as if the payments were made to the Indian residents.

- Accordingly, second proviso to Section 40(a)(ia) of the Act is required to be read into Section 40(a)(i) of the Act, in the cases where related payments are made to the tax residents of Japan, in as much the Japanese tax residents have taken into account the payments made to them by Indian residents, without deduction of tax, in their computation of income, paid tax thereon and have filed the related income tax returns, under Section 139(1) of the Act.

- As this proviso is held to be having a retrospective effect in the case of Rajeev Kumar Agarwal and as no contrary decision has been brought to the notice, the same would be equally applicable in the AY in the present case.

Penalty or compensatory provision

- The Tribunal observed that in the case of Rajeev Kumar Agarwal, the payment was disallowed under Section 40(a)(ia) to compensate for the loss of revenue by corresponding income not being taken into account in computation of taxable income in the hands of the recipients of the payments. The Tribunal observed that such a policy which motivated deduction restrictions should therefore, not come into play when the taxpayer is able to establish that there is no actual loss of revenue.

- This disallowance does de incentivise non-deduction of tax when due for deduction, but, so far as the legal framework is concerned, this provision is also not for the purpose of penalising for the tax deduction lapses.

- Section 40(a)(ia) of the Act is not a penalty for not withholding of tax but it is a sort of compensatory deduction restriction for an income going to be untaxed due to tax withholding lapse, as penalty for tax withholding lapse per se is separately provided for in Section 271C of the Act.

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9 Rajeev Kumar Agarwal v. ACIT [2014] 149 ITD 363 (Agra)
10 Where the taxpayer (payer) fails to deduct the whole or part of the tax in accordance with chapter XVII-B on any such sum but is not deemed to be ‘assessee in default’ under first proviso to Section 201, it shall be deemed that the taxpayer has deducted and paid the tax on such sum on the date of furnishing of return of income by the resident payee

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In view of the above, the disallowance under Section 40(a)(i) of the Act was deleted on the ground that the MCJ, the recipient, has taken into account the related payments in computing its business income in India, paid taxes on the same and duly filed, under Section 139(1), its income tax return in India.

The Tribunal did not deal with the issue whether Section 40(a)(i) of the Act itself will not apply to the facts of the present case in view of Article 24(3) of the tax treaty as the Tribunal has ruled in favour of the taxpayer in its own case in the preceding AY.

Our comments

Generally, a non-discrimination clause in tax treaties provides that nationals of one contracting state shall not be subjected in the other contracting state to any taxation or any requirement connected therewith which is much more onerous, than it is on the nationals of that other contracting state.

The Delhi Tribunal in the present case held that a different tax treatment to the foreign enterprise per se is enough to invoke the non-discrimination clause in the India-Japan tax treaty. Accordingly, the Tribunal deleted the disallowance under Section 40(a)(i) of the Act on the grounds that the non-resident recipient has taken into account the related payments in computing its business income in India, paid taxes on the same and duly filed its income tax return in India.

The Mumbai Tribunal in the case of Central Bank of India had held that the taxpayer was not liable to withhold taxes while making payments to the USA based credit card agencies in view of non-discrimination clause under Article 26(3) of the India-USA tax treaty. Accordingly, such payments were not disallowed under Section 40(a)(i) of the Act on account of non-deduction of tax while making payments to non-residents. Various benches of the Tribunal have also considered this issue and held in favour of the taxpayers.

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12 Central Bank of India v. DCIT [2010] 42 SOT 450 (Mum)
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