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TAX FLASH NEWS

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Payment of administrative fees to foreign company is not liable for disallowance under Section 40(a)(i) of the Income-tax Act for non-deduction of tax at source in view of non-discrimination clause under the India-USA tax treaty

Background

Recently, the Delhi High Court (High Court) in the case of Herbalife International India Pvt. Ltd[1] (the taxpayer) held that payment of administrative fees to foreign company is not liable for disallowance under Section 40(a)(i) of the Income-tax Act, 1961 (the Act) for non-deduction of tax at source in view of non-discrimination clause under the India-USA tax treaty (tax treaty).

Facts of the case

- The taxpayer is the Indian subsidiary of Herbalife International Inc. (HII), USA, engaged in the business of trading and marketing of herbal products for use in weight management, to improve nutrition and enhance personal care.
- The taxpayer entered into an Administrative Services Agreement (ASA) with Herbalife International of America Inc. (HIAI) for providing data processing services, accounting, financial and planning services, marketing services, etc. In terms of the agreement, the taxpayer was to pay an administrative fee to HIAI as consideration for the various services provided to the taxpayer under the ASA. During the Assessment Year (AY) 2001-02, the taxpayer claimed the administrative fee as expenditure while computing its taxable income.
- The Assessing Officer (AO) held that the administrative expenditure was to be treated as Fees for Technical Services (FTS) since the services were utilised in India. Therefore, the taxpayer was liable to deduct tax at source under Section 195 of the Act on the said amount. On account of non-deduction of tax, the AO disallowed the expenditure under Section 40(a)(i) of the Act. The Commissioner of Income-tax (Appeals) [CIT(A)] upheld the order of the AO.
- The Income-tax Appellate Tribunal (the Tribunal) held that administrative fees paid by the taxpayer to HIAI were allowable as deduction. It was held that Section 40(a)(i) of the Act could not be invoked by the AO to disallow the claim for deduction as the payment was not taxable at the hands of the payee. The Tribunal held that HIAI did not have a permanent establishment (PE) in India. Further in light of Article 26(3) of the tax treaty, Section 40(a)(i) of the Act was discriminatory and could not be invoked to disallow the claim of the taxpayer for deduction even if the sum in question was chargeable to tax in India.

[1] CIT v. Herbalife International India Pvt Ltd. (ITA No. 7/2007) – Taxsutra.com

High Court's ruling

Applicability of Article 26(3) of the tax treaty

- There are specific kinds of payments[2] mentioned under Article 26(3) of the tax treaty and it requires treatment in the same manner vis-à-vis a resident and a non-resident.
- The payment mentioned under Article 26(3) of the tax treaty shall be deductible under the 'same conditions' that apply to such payment being made to a resident of contracting state (India in this case). It has been observed that Article 26(3) of the tax treaty borrows the text and language of Article 24 of the OECD Model Convention.
- The High Court observed that the exceptions mentioned in the Article 26(3) of the tax treaty did not apply to the facts of the present case.

Other disbursements

- The tax department invokes the doctrines of '*noscitur-a-sociis*' and '*ejusdem generis*'[3]. It was contended that FTS does not qualify as 'other disbursements' since it is not a passive character like royalties and interest. However, the High Court did not agree with the tax department's contentions. In the context of which the expression 'other disbursement' occurs in Article 26(3) of the tax treaty, it connotes something other than 'interest and royalties'.
- If the intention was that 'other disbursements' should also be in the nature of interest and royalties then the word 'other' should have been followed by 'such' or 'such like'. Therefore, there was no warrant, to proceed on the basis that the expression 'other disbursements' should take the colour of 'interest and royalties'.
- The expression 'other disbursements' occurring in Article 26(3) of the tax treaty is wide enough to encompass the administrative fee paid by the taxpayer to HIAI, which the tax department had chosen to characterise as FTS within the meaning of Explanation 2 to Section 9 (1)(vii) of the Act.

Section 40 (a)(i) of the Act

- Section 40(a)(i) of the Act, as it was during the AY in question did not provide for deduction of tax where the payment was made in India. The requirement of deduction of tax on payments made in India to residents was inserted, for the first time in Section 40(a)(ia) of the Act with effect from 1 April 2005.
- The OECD Expert Group[4] envisages deduction of tax while making payments to non-residents. It is viewed only as additional compliance of verification requirement which would not attract the non-discrimination rule.
- As far as payment to a non-resident is concerned, Section 40(a)(i) of the Act as it stood at the relevant time mandated that if no tax is deducted at the time of making such payment, it will not be allowed as deduction while computing the taxable profits of the payer. No such consequence was envisaged as far as payment to a resident was concerned. Therefore, it attracts the non-discrimination rule under Article 26(3) of the tax treaty.
- Section 40(a)(i) of the Act, in providing for disallowance of a payment made to a non-resident if the tax is not deducted, is no doubt meant to be a deterrent. In the case of Azadi Bachao Andolan[5] the Supreme Court observed that treaty negotiations are largely a

[2] These payments include interest, royalty, and other disbursements
[3] Ejusdem Generis is a Latin term which means 'of the same kind', it is used to interpret loosely written statute

[4] Application and Interpretation of Article 24(Non-Discrimination), Public Discussion Draft, May 2007
[5] Union of India v. Azadi Bachao Andolan [2003] 263 ITR 706 (SC)

bargaining process with each side seeking concessions from the other, the final agreement will often represent a number of compromises, and it may be uncertain as to whether a full and sufficient *quid pro quo* is obtained by both sides.

- Under Section 40(a)(i) of the Act, as it then stood, the allowability of the deduction of the payment to a non-resident mandatorily required deduction of tax at the time of payment. However, payments to residents were neither subject to the condition of deduction of tax at source nor to the further consequence of disallowance of the payment as a deduction.
- The expression 'under the same conditions' in Article 26(3) of the tax treaty clarifies the nature of the receipt and conditions of its deductibility. It is relatable not merely to the compliance requirement of deduction of tax. The lack of parity in the allowing of the payment as the deduction is what brings about the discrimination.
- Since it is mandatory under Section 40(a)(i) of the Act for the payer to deduct tax from the payment to the non-resident, the latter receives the payment net of tax. The object of Article 26(3) tax treaty was to ensure non-discrimination in the condition of deductibility of the payment in the hands of the payer where the payee is either a resident or a non-resident. That object would get defeated as a result of the discrimination brought about qua non-resident by requiring the tax to be deducted while making payment of FTS in terms of Section 40(a)(i) of the Act.
- The provisions of the tax treaty would prevail over the Act unless the Act is more beneficial to the taxpayer. Therefore, except to the extent a provision of the Act is more beneficial to the taxpayer, the tax treaty will override the Act. This is irrespective of whether the Act contains a provision that corresponds to the treaty provision. Accordingly, it has been held that Section 40(a)(i) of the Act is discriminatory and therefore, not applicable in terms of Article 26(3) of the India-USA tax treaty.

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 requirement connected therewith which is much more onerous, than it is on the nationals of that other contracting state.

The Delhi High Court in the instant case held that under Section 40(a)(i) of the Act, expenditure is allowed only when tax has deducted at source while making payment to non-resident. However, for the relevant AY the payments to a resident were neither subject to the deduction of tax, nor the consequence of disallowance was applicable. Accordingly, it was held that Section 40(a)(i) of the Act is discriminatory and therefore, not applicable in terms of non-discrimination clause under the tax treaty.

The Delhi Tribunal in the case of Mitsubishi Corporation India Pvt Ltd[6], relying on the non-discrimination clause under the India-Japan tax treaty, 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[7].

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[6] Mitsubishi Corporation India Pvt. Ltd v. DCIT (ITA No. 5042/Del/11)

[7] 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.

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