



Deduction of hypothetical tax and contribution towards social security charges

Background

The Income-tax Appellate Tribunal, Pune¹ has held that the deduction in respect of hypothetical tax² as per the tax equalization policy of the home country employer and employee contribution towards social security charges paid outside India should be allowed to the expatriate employee deputed to work in India.

Facts of the case

- M/s Skoda Auto a.s ('the foreign company'), a company incorporated in Czechoslovakia ('home country') deputed its employee ('tax payer'), a Czech national, to work with Skoda Auto India Private Limited.
- In the return of income filed by the tax payer, a deduction in respect of hypothetical tax ('hypo tax') and contribution towards social security charges paid in the home country was claimed from the base salary and net salary was offered to tax in India.

Issues before the Tribunal

- Whether hypo tax can be allowed as a deduction from the base salary chargeable to tax in India?

¹ The IncomeTax officer , Aurangabad v. Lukas Fole (ITA No. 1228/PN/08)

² Under a tax equalization policy framed by the Company, the employer provides that the company shall bear the employees tax liability arising out of the foreign assignment. But the employers liability will be restricted only to the extent of additional liability over and above what would have arisen had the assignee stayed back at home. Hypothetical tax is the tax that is payable by the employee had he continued to stay in his home country and not accepted the foreign assignment.

- Whether the employee's contribution towards social security charges can be allowed as a deduction from base salary chargeable to tax in India?

Tax payer's contention

- The deduction of hypo tax was claimed under the tax equalization policy of the foreign company.
- In the case of Jaidev H Raja³, it was held that the taxable base salary is to be reduced by the amount of hypo tax. Accordingly, deduction of hypo tax was claimed from the base salary offered to tax in India.
- As regards social security charges in the home country, the tax payer does not have any enforceable right vested in him. No benefit accrued to the tax payer under the social security plan of the home country in the relevant financial year⁴.
- Reliance was placed on the case of Gallotti Raoul⁵, wherein it was held that only the net income was chargeable to tax after adjustment of French social security charges. Accordingly, deduction in respect of social security charges was claimed from the base salary offered to tax in India.

Assessing officer's contention

- In the case of Jaidev H Raja, gross income was offered to tax and tax liability on that income was paid, as against deduction of hypo tax from the base salary in the taxpayer's case.
- Hypo tax is not a permissible deduction from salary income under the Income-tax Act, 1961 ('the Act'). Accordingly, deduction of hypo tax cannot be granted from the base salary.
- Further, there is no specific deduction under the Act or India-Czechoslovakia tax treaty ('tax treaty') in respect of the contribution towards social security charges. Therefore, no deduction can be allowed for the same from the base salary chargeable to tax in India.

Decision of Commissioner Income-Tax (Appeals) [CIT(A)]

- The decision in the case of Jaidev H Raja is squarely applicable on the facts of the instant case.
- The hypo tax is not accrued to the tax payer at all and the same is not taxable. Accordingly, the deduction of hypo tax has been rightly claimed by the tax payer.

³ ITA No.2021/Mum/98- Income Tax Appellate Tribunal, Mumbai

⁴ 2005-06

⁵ 61 ITD 453- Income Tax Appellate Tribunal, Mumbai

- In respect of social security charges, the domestic law of the Czech Republic lays down a compulsion whereby all citizens are required to contribute towards social security plan, regardless of the place of work.
- The contributions towards social security plan never reach the employee as his income. Therefore, non- existence of a specific deduction in respect of this contribution under the Act or tax treaty is immaterial.
- Therefore, the tax payer is justified in claiming the deduction in respect of said contribution, keeping in view the case of Gallotti Raoul.

The Tribunal Ruling

- The deduction of hypo tax is made under the tax equalization policy of the employer, which restricts the tax liability of an employee in India to the liability he would have incurred in his home country, if not sent on deputation.
- On the issue of deductibility on account of hypo tax from base salary of the tax payer, while holding that there is no doubt the issue is in favour of the tax payer, the Tribunal deliberated on whether the deduction is to be allowed while computing the basic salary or it is to be allowed at the stage of computing tax perquisite (i.e. tax of the employee borne by the employer).
- The Tribunal expressed that the hypo tax only reduces the tax perquisite and not the base salary of the employee. Therefore, in principle, the hypo tax should be reduced from the tax perquisite and not from the basic salary. In the instant case as there was no tax impact whatever be the method of claiming the deduction, they did not disturb the conclusions of the CIT(A).
- As regards social security charges, the decision of the CIT (A) was upheld and deduction allowed.

Our Comments

As per this judgement, gross base salary is required to be offered to tax instead of salary net of hypo tax. The hypo tax is to be reduced from the tax borne by the employer. This method of claiming a deduction for hypo tax will have implications in instances wherein base salary is considered among other components, as the basis for calculation of perquisites e.g. Rent free accommodation, tax paid by employer on non-monetary perquisite etc and the final tax liability of the individual may witness a change.

Also on deduction towards employee contributions to overseas social security, the relevant domestic law of the home jurisdiction levying such a charge has to be examined in detail.

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For further information about KPMG in India and our services, please contact:

Bangalore

Maruthi Infotech Centre, 11-12/1
Inner Ring Road
Koramangala, Bangalore 560071
Phone: + 91 80 3980 6000 Fax: +91 80 3980 6999

Chennai

KPMG House
No.10, Mahatma Gandhi Road,
Nungambakkam High Road,
Chennai 600034
Phone: +91 44 39145000 Fax: +91 44 39145999

Delhi

DLF Cyber City, Building no. 10, Block B, Phase II
Gurgaon, Haryana 122 002
Phone: +91 124 307 4000 Fax: +91 124 254 9195

Hyderabad

KPMG, 8-2-618/2
Reliance Humsafar, 4th Floor
Road No.11, Banjara Hills
Hyderabad - 500 034
Phone: +91 40 66305000/23350060 Fax: + 91 40 6630 5299

Kolkata

Park Plaza, Block F, Floor VI
71 Park Street, Kolkata 700 016
Phone: +91 33 2217 2858 / 64/62 Fax: +91 33 2217 2868

Mumbai

KPMG House, Kamala Mills Compound, 448 Senapati Bapat Marg
Lower Parel, Mumbai 400 013
Phone: +91 22 39896000 Fax: + 91 22 39836000

Pune

703, 7th Floor Godrej Castlemaine, Next to Ruby Hall Clinic,
Bund Garden Road, Pune 411001
Phone: +91 20 30585764/65 Fax: +91 20 3058 5775

Kochi

4/F, Palal Towers
M. G. Road, Ravipuram,
Kochi 682 016
Tel: +91 484 309 4120
Fax: +91 484 309 4121