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TAX FLASH NEWS

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Interest and fees earned by a foreign bank in connection with providing loans to Indian clients are taxable as interest income and not as business income under the India-Germany tax treaty

Recently, the Mumbai Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of DZ Bank AG – India Representative Office[1] (the taxpayer) held that interest income, commitment charges and agency fees earned by the taxpayer from Indian clients are taxable as interest income under Article 11 and not as business income under Article 7 of the India-Germany tax treaty (tax treaty). The interest income could be taxable as business income only when the twin conditions i.e. foreign enterprise carried on business in the source jurisdiction and that the debt claim being effectively connected with the Permanent Establishment (PE) are satisfied. However, in the present these two conditions are not satisfied and hence, the entire interest income is taxable under Article 11 of the tax treaty.

Facts of the case

The taxpayer, a German company is engaged in the banking business. The taxpayer has its principal place of business in Germany and a representative office in India as permitted by the Reserve Bank of India (RBI). In terms of the RBIs conditions, the representative office was to act as a Liaison Office (LO) without transacting any type of banking business and all the expenses of the representative office were to be met out of inward remittances from the bank. The representative office was not engaged in the core business of the taxpayer, i.e. banking. During the Assessment Year 2014-15, the taxpayer provided foreign currency loans to Indian companies which were in the nature of External Commercial Borrowings (ECB). The taxpayer earned interest from such ECB. Further, the taxpayer earned a commitment fee and agency fees in connection with the loans guaranteed.

The taxpayer contended that Tax deduction at Source (TDS) on interest payable by the Indian borrowers was borne by them. Further, the foreign company is exempt[2] from furnishing a return of income in India when it only earns interest income from foreign currency loans provided to Indian companies, and the appropriate taxes have been deducted at source from the same. Accordingly, such income was not taxable.

The Assessing Officer (AO) held that the business transaction by the taxpayer's head office and overseas branches with its Indian clients would not be complete without the involvement and actions by its representative office in India. Therefore, the income shall be deemed to accrue/arise to the taxpayer from 'business connection' in India. The AO held that the representative office of the taxpayer in India would constitute a Permanent Establishment (PE) under the tax treaty. Therefore, profits deemed to accrue or arise to the taxpayer in India which are attributable to the PE under the tax treaty.

While referring to Explanation 2 to Section 9(1)(i) of the Income-tax Act, 1961, the AO held that the taxpayer habitually exercises in India, an authority to conclude contracts for or on behalf of the enterprise at the instructions of the head office or overseas branches. Indian representative office also habitually secures orders in India, wholly for the foreign entity and its overseas branches. Thus, all the income earned by its head office from clients in India is taxable as its business income in India. The Commissioner of Income-tax (Appeals) [CIT(A)] upheld the order of the AO. Aggrieved, the taxpayer filed an appeal before the Tribunal.

[1] DZ Bank AG – India Representative Office v. DCIT (ITA No. 1815/Mum/18) – Taxsutra.com

[2] As per Section 115A(5) of the Act

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Tribunal's decision

Taxability in the hands of foreign company and not in the hands of a Representative Office in India

The Tribunal observed that it is only elementary that the tax subject is only the foreign enterprise and not its PE in India, though, so far as profit attributable to the PE are concerned, the same are taxable in the hands of the foreign enterprise. The Tribunal in the case of Dresdner Bank AG[3] observed that in so far as foreign companies are concerned, taxable unit is a foreign company and not its branch or PE in India, even though the taxability of such foreign companies is confined to (i) an income which 'accrues or arises in India' or is 'deemed to accrue or arise in India', and (ii) an income which is received or is deemed to be received by or on behalf of such foreign company. Reference was made to the decision of the Supreme Court in the case of Hyundai Heavy Industries Co Ltd[4]. Thus it was held that India Representative Office was not a taxable unit, and the taxable entity was only foreign entity.

Taxability as interest income under Article 11 and not as business income under Article 7

The Tribunal, on perusal of Article 7 of the tax treaty observed that when a particular type of income is specifically covered under the tax treaty provision, the taxability of that type of income is governed by the specific provisions of the tax treaty. There was no dispute that income earned by the taxpayer from Indian clients was in the nature of 'interest' income, and Article 11 had specific provisions for taxation of interest income, in the hands of a resident of one contracting state, from the other contracting state. Interest income is specifically covered in Article 11[5] of the tax treaty and restricts the taxability of such interest income to 10 per cent of the gross amount. Further, the interest relating to the India operations of the foreign entity have been offered to tax under Article 11. Therefore, the interest income was to be taxed on gross basis, in the source jurisdiction subject to, certain exemptions which are not relevant in the present context.

The exclusion clause under Article 11(5) will be triggered only when the twin conditions, that the foreign enterprise carried on business in the source jurisdiction and that the debt claim being effectively connected with the PE are satisfied. So far as the debt claim being effectively connected with the PE is concerned, that cannot come into play only merely because the PE had a supporting role in creation of the debt claim. Unless a debt claim is part of the assets of the PE or income arising therefrom can be said to be income of the PE, it cannot normally be treated as effectively connected with the PE.

When principal transaction (i.e. interest income in question) itself does not lead to taxable income in India, a transaction subsidiary thereto (i.e. commitment fees and agency fees relatable thereto) cannot result in an income taxable in India either. Commitment charges and agency fees are an integral part of the loan arrangements, relatable to the same loan, and part of consideration for the same loan.

There was no income, other than the interest income of the taxpayer from its clients in India, on which tax liability under Article 11 has already been discharged. So far as this taxability is concerned, the taxpayer did not have any obligations to file the income tax return under Section 115A(5) as it existed at the relevant point of time. In this case, an income, which has already been brought to tax in the hands of the taxpayer under a treaty provision, is being sought to be taxed again in the hands of the same taxpayer, in the same assessment year but only under a different provision. Such an approach is not correct.

Therefore, the entire interest income was to be taxed under Article 11 and not under Article 7 of the tax treaty.

Permanent Establishment

It is wholly academic issue as to whether or not the taxpayer had a PE in India, because PE or no PE, the debt claim in question could not be said to be effectively connected to the alleged PE, and, therefore, neither the exclusion of Article 11(5) could have been triggered, nor the taxability under article 7 could not have come into play.

It is not even AO's case that the debt claims in question are effectively connected with the PE, but at best that there is a real relation between the business carried on by the taxpayer for which it receives interest and processing charges abroad and activities of its representative office in India which contribute directly or indirectly to the earning of income of the taxpayer. Thus, something is much less than the threshold nexus level to trigger Article 11(5) exclusion clause.

Thus, the existence of PE is not really relevant for determining the issue of taxability under Article 7 on the facts of the present case.

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[3] Dresdner Bank AG v. ACIT [2006] 11 SOT 158 (Mum)
[4] CIT v. Hyundai Heavy Industries Co Ltd [2007] 291 ITR 482 (SC)
[5] Interest income arising in a contracting state and paid to a resident of the other contracting state may be taxed in the other contracting state

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Our comments

The taxability of interest income earned by a foreign bank and its effective connection with a PE in India has been a subject matter of debate before the Courts/Tribunal.

The Special Bench of the Delhi Tribunal in case of Clough Engineering Ltd.[6] held that interest income earned by a tax resident of Australia in India; on refund of tax dues could not be treated as business income under Article VII of India-Australia tax treaty as such refund was not effectively connected with the Indian PE of the taxpayer. Similarly, the Mumbai Tribunal in the case of Bechtel International Inc.[7] held that the interest on income-tax refund would be taxable as interest income at 15 percent on gross basis and not as business income (at 40 percent) since it was not effectively connected to the PE.

However, the Uttarakhand High Court in the case of B.J. Services Company Middle East Limited[8] held that the interest income is taxable as business income under the India-U.K. tax treaty since the debt claim in respect of which interest is paid, was effectively connected with a PE in India.

The Tribunal in the present case has held that the interest income earned by the taxpayer from its Indian clients is taxable under Article 11 of the tax treaty and not under Article 7 as business income. The interest income could be taxable as business income only when the twin conditions i.e. foreign enterprise carried on business in the source jurisdiction and that the debt claim being effectively connected with the PE are satisfied. However, in the present these both these conditions were not satisfied and hence, the entire interest income was held to be taxable under Article 11 of the tax treaty.

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[6] ACIT v. Clough Engineering Ltd [2011] 11 taxmann.com 70 (Del)
[7] Bechtel International Inc. v. ADIT [2012] 135 ITD 377 (Mum)
[8] B.J. Services Company Middle East Limited v. ACIT [2016] 380 ITR 138 (Uttarakhand)

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