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TAX FLASH NEWS

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Foreign tax credit allowed on the basis of 'gross receipts'

Background

Recently, the Ahmedabad Bench of the Income-tax Tribunal (the Tribunal) in the case of Elitecore Technologies Private Limited[1] (the taxpayer) held that the Foreign Tax Credit (FTC) is eligible on 'income' and not on 'gross receipts'. However, based on peculiar facts of the instant case, the Tribunal allowed the FTC to the taxpayer on the basis of 'gross receipts'.

Facts of the case

- The taxpayer, a wholly owned subsidiary of a U.S-based company, engaged in the business of software development and products.
- During the relevant previous year, the taxpayer did not have any income taxable under the normal provisions of the Act. It has computed the book profits under Section 115JB at INR4,77,79,500 and accordingly, tax liability, under Minimum Alternate Tax (MAT) provisions, was computed at INR54,13,417.
- During the course of the scrutiny assessment proceedings, the Assessing Officer (AO) noted that the taxpayer has claimed a foreign tax credit of INR11,12,907. This credit was in respect of the taxes withheld abroad, i.e. in Singapore and Indonesia.
- The taxpayer had received certain amount, after deduction of tax at source at the rate of 10 per cent i.e. INR5,41,029, from a Singapore based concern by the name of IBM Corporation.
- The taxpayer had also received certain amounts, after deduction of tax at source at the rate of 15 per cent i.e. INR5,71,878, from an Indonesia based company by the name of P T Tech Mahindra. It was the aggregate of these tax deductions, which comes to INR11,12,907, that the taxpayer had claimed as the foreign tax credit.
- The AO, however, did not approve the claim of the taxpayer. The AO was of the view that the tax credit is to be allowed only to the extent corresponding income (profit after deduction of all allowable expenditure) has suffered tax in India, and that the extent to which income has suffered tax in India in respect of these receipts is to be computed by reference to the actual MAT liability being divided in the same ratio as the ratio of corresponding foreign receipts to the overall turnover of the taxpayer. The amount of eligible tax credit was thus worked out to INR75,935.
- The taxpayer contended that the gross receipts, which is what are material for the purpose of computing the tax credit even if the ratio of foreign receipts to the overall receipts are to be taken into account

Tribunal's ruling

- India-Singapore and India-Indonesia tax treaties state that the foreign tax credit shall not exceed the part of the income tax as computed before the deduction is given, 'which is attributable as the case may be, to the income which may be taxed in that other State' but there is little guidance on how to compute such income.

[1] Elitecore Technologies Private Limited v. DCIT (ITA No.623/Ahd/2015) – Taxsutra.com

- However, quite clearly, as the expression used is ‘income’, which is essentially implied ‘income’ embedded in the gross receipt, and not the ‘gross receipt’ itself. This approach is reflected in the UN Model Convention Commentary as well, which, in turn, follows the approach in OECD Model Convention Commentary in this regard.

- The UN Model Convention Commentary states that ‘normally the basis of calculation of income tax is total net income, i.e. gross income less allowable deductions. Therefore, it is the gross income derived from the source state less any allowable deductions (specific or proportional) connected with such income which is to be exempted’.

- It is, therefore, not really the right approach to take into account the gross receipts, as was contended by the taxpayer, for the purpose of computing admissible tax credit.

- However, the instant case is somewhat unique in the sense that the main business is carried on in India and only some isolated transactions have taken place in Singapore and Indonesia. These transactions are only for release of margin money and addition of a separate user which do not require any activity on the part of the taxpayer. In a way, therefore, these earnings are, so far as the present year is concerned, are passive earnings, and no part of the costs incurred in India can be allocated to earnings from Singapore and Indonesia. Further as regards earnings from maintenance contract received from Indonesia, the taxpayer has allocated the costs on a proportionate basis and no defects are pointed out in the allocation so made by the taxpayer.

- However, there seems to be no logic in allocating a share, in proportion of turnover, of all the costs borne by the taxpayer to these earnings as has been done by the AO. When the income in respect of such foreign operations is not separately computed, it is to be done on a reasonable basis, and what would constitute reasonable basis will be the basis which is based on sound reasoning.

- The concept of averaging on the basis of overall revenues and profits of the taxpayer, or on the basis of some other ratio analysis, can only come into play when the income element cannot be worked out on some other reasonable basis on the facts of a particular case.

- So far as the facts of the present case are concerned, the taxpayer has, during the course of the assessment proceedings, given the working on the computation of income. No infirmities were found in this computation showing the element of income embedded in the receipts, which have been taxed abroad as well.

- On a perusal of these details, it was observed that as far as retention money of INR53,23,085, released after validation of software by IBM Singapore is concerned, it was uncontroverted claim of the taxpayer that entire related expenses have been incurred in the earlier years as the software supply was completed in financial year 2006-07. There cannot obviously be any incremental cost at the point of time when retention money of 15 per cent of total contract value is released.

- The same is the position in respect of receipt of INR31,61,369 from PT Tech Mahindra is concerned, which is only for additional user of software already supplied to the customer.

- When an additional user is added by the customer, it does result in revenue to the seller but it does not at all add to his costs. There is thus merit in the plea that entire receipt, as in the case of release of retention money, is in the nature of income in this year.

- The taxpayer has also received INR5,74,060 form PT Tech Mahindra, which was in respect of annual maintenance fees but then there is a dedicated team for this purpose and the costs relatable to this particular receipt have been computed by apportioning these costs. There was no infirmity in this computation either. Therefore, the computation of income element, as given by the taxpayer, is fair and reasonable and, in any event, the AO has not pointed out any specific infirmities in the same.

- Given this analysis, there is no need to compute the profit element by taking into account the ratio of entire income to entire turnover of the taxpayer.

- However, this decision cannot be the authority for the general proposition that only marginal or incremental costs incurred in respect of foreign income should be taken into account and the overheads cannot be allocated thereto. The allocation of proportional deductions can be justified in some situations, such as when business operations are somewhat evenly or even in a significant manner, spread over the residence and source jurisdiction, but that's not the case here.

- In the instant case, major portion of income, by release of retention money as also by addition of an additional user by the customer, is a somewhat passive income, even though in the nature of business receipt, and as such, to that extent, allocation of all the expenses incurred by the taxpayer, in respect of such earnings, will not be justified.

- Accordingly, quantification of income for the purpose of computing admissible tax credit, as done by the taxpayer has been accepted.

- Tax credit for both the jurisdictions is to be computed separately but in a similar manner, as is provided in the respective treaties. So far as the tax credit in respect of Indonesian receipts is concerned, in view of Article 23(1) of the applicable tax treaty, it cannot 'exceed the part of the income tax as computed before the deduction is given, which is attributable as the case may be, to the income, which may be taxed in that other State'. The income tax is, therefore, required to be computed on proportionate basis. What is, therefore, to be computed next is the tax attributable to the income, which is so taxed in both the tax jurisdictions.

- The tax has been paid, in this case, on book profits. The Tribunal observed that to the best of its understanding, and particularly in the absence of any other method having been pointed out, only way in which be so done is by apportioning the actual tax paid under MAT provisions (i.e. INR54,13,417), in the same ratio as double taxed profit to the overall profits. The amount of tax credit in respect of this income thus comes to INR4,06,315, as against the actual deduction of tax aggregating to INR5,71,878. The tax credit claim is thus admissible to this extent.

- As for the tax credit in respect of Singaporean receipts, while the formulae for limitation under article 25(2) of the Indo Singapore tax treaty remains broadly the same. The figure of income, taxed in Singapore as well as in India, is INR53,23,085. The tax credit of INR5,41,029 in respect of Singaporean receipts is thus clearly admissible.

- As against tax credit claim of INR11,12,907, the tax credit of INR9,47,344 is thus admissible. To this extent, the claim of the taxpayer is upheld.

Our comments

Allowability of foreign tax credit has been a subject matter of debate before the Courts/Tribunal. The Ahmedabad Tribunal in this decision recognised that the FTC is to be computed on the basis of 'income' and not on the basis of 'gross receipts'. However, based on the peculiar facts of the instant case, the Tribunal has given relief to the taxpayer by allowing computation of the FTC on the basis of 'gross receipts'.

In June 2016, the Central Board of Direct Taxes[2] introduced FTC rules which will come into effect from 1 April 2017. The rules provide clarity on various aspects of claiming FTC. However, the issue with respect to computation of FTC whether on the basis of 'gross receipts' or 'income' has not been dealt by such rules.

[2] CBDT Notification No. 54/2016, dated 27 June 2016

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