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Tax Flash News

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Tribunal allowed set-off of PE loss against ECB interest taxable on gross basis

Executive summary

In the case of *Abu Dhabi Commercial Bank PJSC*[1], the Mumbai Bench of Income-tax Appellate Tribunal (Tribunal) held that business loss attributable to the Permanent Establishment (PE) in India can be set off against interest income earned on External Commercial Borrowings (ECB), extended directly by the overseas head office to Indian customers (i.e., which was not attributable to the PE).

The Revenue contended that the India-UAE tax treaty[2] (treaty) mandates taxation of interest on a gross basis, without allowing for deduction of any expenses or losses, and lacks any enabling provision for such set-off of losses.

However, the Tribunal rejected the Revenue's argument, holding that the treaty allows computation of interest income in accordance with the provisions of the Income-tax Act, 1961 (the Act). Accordingly, the set-off provisions under the Act must be applied to determine total income, upon which the beneficial tax rate under the treaty is to be levied.

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[1] *Abu Dhabi Commercial Bank PJSC* v. *DCIT (International Taxation)* (ITA No. 3404/ MUM/ 2023)

[2] Article 11 - Interest

Facts of the case

The taxpayer, a UAE tax resident engaged in banking operations, had a PE in India. The UAE head office extended ECB loans directly to Indian customers, without routing the same through the Indian PE.

During the relevant year, the Indian PE suffered business losses, which the taxpayer set off against ECB interest income. The net interest income was then offered to tax under the head “income from other sources” at the beneficial tax rate of 5 percent under the treaty[3]. The taxpayer took an alternative plea that even if the treaty tax rate is denied, the ECB interest qualifies for a concessional tax rate of 5 per cent under the Act[4].

The Revenue disallowed the set-off, citing absence of a specific provision in the treaty permitting loss set-off. The Revenue further argued that as the loan agreements have not been approved by the Central Government (CG), the ECB interest does not qualify for the concessional tax rate of 5 per cent under the Act but is taxable at the rate of 20 per cent under the Act.[5]

[3] Article 11(2)
[4] Section 115A(1)(a)(iiaa) read with section 194LC
[5] Section 115A(1)(a)(ii)

Relevant provisions

As per Article 11(2) of the treaty, interest arising in India and paid to UAE tax resident may be taxed in India as per the relevant provisions of the Act, but the tax so charged shall not exceed 5 per cent of the gross amount of the interest, provided the interest is paid on a loan granted by a *bona fide* banking institution[6].

Section 115A(1)(a)(iiaa) read with section 194LC of the Act prescribes a tax rate of 5 percent on interest paid by an Indian company on foreign currency loan, under a loan agreement approved by the CG.

Further, section 115A(1)(a)(ii) of the Act provides that interest income not covered under section 194LC is taxable at the rate of 20 percent.

Revenue’s contentions

The treaty mandates taxation of the gross amount of the interest, disallowing any deductions. The treaty does not permit set-off of business loss of a PE against non-PE interest income.

[6] In all other cases, the rate of tax shall not exceed 12.5 percent of the gross amount of the interest

Once the taxpayer chooses to be governed by the treaty provisions, it cannot again fall back upon the provisions of the Act to claim the set-off. Such a hybrid approach is not permissible.

The taxpayer's alternative plea is not acceptable due to lack of CG approval for ECB agreements, making the interest income taxable at 20 percent (and not 5 percent) under the Act.

Taxpayer's contentions

The phrase "the gross amount of the interest" in the treaty only precludes deduction of expenses from interest and not loss set-off. Since loss cannot be equated with expense, inter-head loss set off permissible under the Act remains available.

The Act allows the taxpayer to choose either to be governed by the treaty or the Act, whichever is more beneficial, and the computation mechanism under the Act remains available[7]. There is no bar on the taxpayer in going back to the Act, even if it has chosen to be governed by the treaty provisions.

Schedule CYLA in the income tax return specifically facilitates set-off of business losses against "income from other sources", indicating legislative intent to allow such adjustment even for non- resident taxpayers.

As an alternative plea, the taxpayer argued that ECB interest qualified for 5 percent tax rate under the Act, citing CBDT's circular[8] that dispenses with CG approval if ECB guidelines prescribed by the RBI[9] are followed. Since, in the instant case, all ECBs extended satisfy ECB guidelines, no CG approval is required *qua* each loan agreement[10] .

Tribunal's decision

The Tribunal allowed set-off of Indian PE's losses against ECB interest income, before applying the treaty rate. Key observations include:

Article 11(2) of the treaty involves two steps: (i) taxability of interest and its computation under the Act; and (ii) application of treaty rate of 5 percent on the amount so computed.

[7] *Foramer S.A.* v. *DCIT* [1995] 52 ITD 115 (Delhi)

[8] Press release dated 21 September 2012, read with Circular no. 7/ 2012 dated 21 September 2012 issued by the Central Board of Direct Taxes

[9] Reserve Bank of India

[10] *Hitachi Zosen Corporation* v. *JCIT* [1999] 68 ITD 235 (Mumbai Tribunal)

Thus, the computation of income has to be done as per the provisions of the Act and while computing total income, the Act permits set-off of a current year business loss against “income from other sources”[11], with no express prohibition/ restriction on such adjustment for foreign companies.

Only after the income has been computed as per the Act, one has to again revert to the treaty provisions for the tax rate applicable on such income.

Article 25(1) of the treaty provides that the laws in force in India shall continue to govern the taxation of income in India subject to a contrary express provision in the treaty. Article 11(2) itself provides for computation of income as per the provisions of the Act. Thus, it cannot be said that the taxpayer cannot adopt hybrid approach.

In the absence of any definition of word “gross” either in the treaty or in the Act, reference can be made to the OECD Commentary which clarifies that the gross amount of interest means the amount regardless of expenses incurred to earn such interest[12]. Accordingly, the Tribunal held that denying the benefit of loss set-off is not correct.

On the alternative plea, the Tribunal accepted that the ECB interest qualifies for 5 percent tax under the Act, as the taxpayer complied with ECB guidelines by RBI and no CG approval was required.

Our comments

This ruling reinforces the principle that while tax treaties govern the rate of taxation, the computation of total income is governed by domestic law, unless expressly restricted.

[11] Section 71 of the Act

[12] OECD Model Tax Convention on Income and Capital, 2017 - Paragraph 7.1 of the Commentary on Article 11(2)

KPMG in India addresses:

Ahmedabad
Commerce House V, 9th Floor, 902, Near Vodafone House, Corporate Road, Prahlad Nagar,
Ahmedabad – 380 051.
Tel: +91 79 4040 2200

Hyderabad
Salarpuria Knowledge City, Orwell 6th Floor, Unit-3, Survey No 83/1, Plot No 2, Raidurg,
Hyderabad – 500 081.
Tel: +91 40 6111 6000

Noida
Unit No. 501, 5th Floor, Advant Navis Business Park, Tower-A, Plot# 7, Sector 142, Expressway Noida, Gautam Budh Nagar,
Noida – 201 305.
Tel: +91 0120 386 8000

Bengaluru
Embassy Golf Links Business Park, Pebble Beach, 13/02, ‘B’ Block, 1st & 2nd Floor, Off Intermediate Ring Road,
Bengaluru – 560 071
Tel: +91 80 6833 5000

Jaipur
Signature Towers, Office No. 402, Fourth Floor, S Plot No. DC-II, Lal Kothi District Shopping Center, Tonk Road,
Jaipur – 302 001
Tel: +91 141 – 672 1000

Pune
9th floor, Business Plaza, Westin Hotel Campus, 36/3-B, Koregaon Park Annex, Mundhwa Road, Ghorpadi,
Pune – 411 001.
Tel: +91 20 6747 7000

Chandigarh
Elante Offices, Unit No. A505, 5th Floor, Plot No.178-178A, Industrial Area Phase-1,
Chandigarh – 160 002.
Tel: +91 172 664 4000

Kochi
Syama Business Centre, 49/179, 3rd Floor, NH 47, Bypass Road, Vytilla,
Kochi – 682 019.
Tel: +91 484 302 5600

Chennai
KRM Towers, Ground, 1st, 2nd, & 3rd Floor, No. 1, Harrington Road, Chetpet,
Chennai – 600 031.
Tel: +91 44 3914 5000

Kolkata
Unit No. 604, 6th Floor, Tower – 1, Godrej Waterside, Sector – V, Salt Lake,
Kolkata – 700 091.
Tel: +91 33 4403 4000

Mumbai
Lodha Excellus, Apollo Mills Compound, 2nd Floor, N M Joshi Marg, Lower Parel, Mumbai- 400 011.
Tel: +91 22 3989 6000

Vadodara
Ocean Building, 303, 3rd Floor, Beside Center Square Mall, Opp. Vadodara Central Mall, Dr. Vikram Sarabhai Marg,
Vadodara – 390 023.
Tel: +91 265 619 4200

Vijayawada
PR heights, 4th Floor, NH 16 Service Rd, opp. Manipal Hospital Road, Tadepalle,
Andhra Pradesh – 522 501.
Tel: +91 0864 536 2000

Gurugram
Building No.10, 8th Floor, DLF Cyber City, Phase II, Gurugram,
Haryana – 122 002.
Tel: +91 124 307 4000

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KPMG Assurance and Consulting Services LLP, Lodha Excelus, Apollo Mills Compound, NM Joshi Marg, Lower Parel, Mumbai - 400 011 Phone: +91 22 3989 6000, Fax: +91 22 3983 6000