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Tax Flash News

24 May 2024

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Interest paid by a permanent establishment of a foreign bank in India to its overseas head office is not taxable under the tax treaty

Executive summary

In a few earlier decisions, the interest paid by a permanent establishment (PE) of a foreign bank in India to its overseas head office (HO) has been held to be not taxable in the hands of the foreign bank being a payment to the self.

Thereafter, the Finance Act, 2015 introduced a specific provision[1] in the Income-tax Act, 1961 to, *inter alia*, provide that in the case of a foreign bank, any interest payable by its PE in India to the HO is chargeable to tax in India in addition to any income attributable to the PE. For this purpose, the PE is to be treated as a person separate and independent of the HO.

However, there is no similar provision in the interest article of the most of the Indian tax treaties.

The Mumbai bench of the Tribunal in a recent decision[2] held that such interest is not taxable in India under the interest article of the India-France tax treaty (the treaty) in the absence of a specific provision in the treaty.

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[1] Explanation to section 9(1)(v) with effect from 1 April 2016

[2] ITA No.3416/Mum/2023 (Mum) - Source: Taxsutra

Facts of the case

The taxpayer (a resident of France) is a commercial bank having its HO in France.

The taxpayer has eight branch offices (BOs) in India which constituted its PE in India.

The BOs paid interest to the overseas HO and claimed a deduction of the interest paid while computing its business income under the treaty[3].

The taxpayer (the HO) did not recognise such interest as its income taxable in India on the ground that the transaction was in the nature of payment to the self.

[3] Article 7(3) of the treaty

Taxpayer's arguments

The business profit article[4] provides that the profits attributable to a PE should be the profits which the PE might be expected to make if it were a distinct and separate enterprise, and dealing wholly independently with the enterprise of which it is a PE.

This deeming fiction of hypothetical independence was for the limited purpose of determining the profits attributable to the PE and cannot be extended or applied to the interest article[5].

The interest article defines the term 'interest' to mean income from 'debt-claims' which requires two parties. A 'debt' ordinarily is a sum of money due from one person to another[6].

For the purposes of the term 'person' under the Act as well as under the treaty, the branch and the foreign bank are to be treated as the same taxable unit[7].

In the instant case, two parties were not involved, and it was merely payment to the self. Therefore, the payment by the BO to its HO was not in the nature of interest under the treaty.

[4] Article 7(2) of the tax treaty

[5] Article 12 of the treaty

[6] *Canara Bank* v. *Tecon Engineers* [1994] 207 ITR 691 (Ker)

[7] *Sumitomo Mitsui Banking Corporation* v. *DDIT* [2012] 145 TTJ 649 (Mum) (SB))

Taxpayer's arguments…

The interest was paid in respect of a debt-claim which was effectively connected to the taxpayer's PE and thus, was outside the scope of the interest article[8].

The India-USA tax treaty[9] contains specific provisions to tax the interest payable by a branch to its HO. In the absence of a similar provision in the India-France treaty, the interest was not taxable in the hands of the HO.

Revenue's arguments

The interest article of the treaty refers to interest arising in India and does not refer to interest paid by a resident of India. Therefore, the interest paid by the PE in India was liable to tax in India under the treaty.

The debt on which interest was paid was not effectively connected with the PE. It was connected to the HO. The business profit article was not applicable to such interest.

Tribunal's decision

Though the interest paid by the PE to the HO is taxable under the Act by virtue of the specific provision, such interest was not taxable under the interest article of the treaty in the absence of a similar specific provision.

The debt claim means some money is due from one person to another. In the instant case, the PE has borrowed money from the HO and thus, the debt on which interest was paid was connected to a PE. Such interest was outside the scope of the interest article[10].

The interest income of the HO can be taxed under the interest article only when the HO does not have a PE in India. However, in the instant case, the taxpayer had a PE in India and in such a case, only the business profits article would apply to deal with the taxability of profit attributable to the PE.

[8] As per Article 12(5) of the treaty

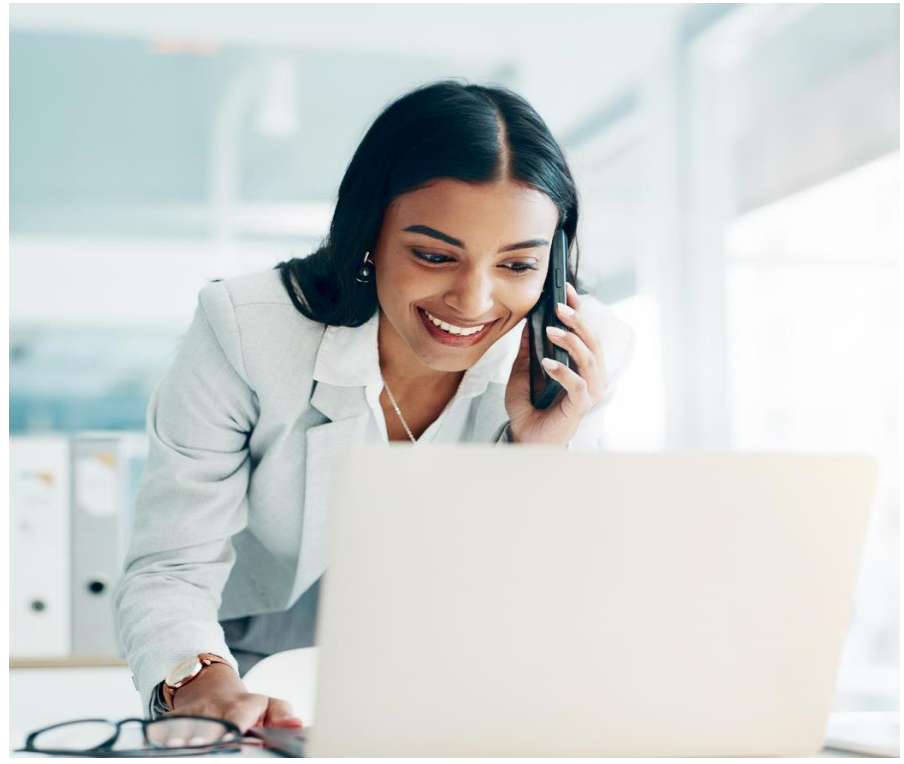
[9] Article 14(3) of the India-USA tax treaty provides that in the case of a banking company which is a resident of the USA, the interest paid by the PE of such a company in India to the HO is subject to tax in India

[10] As per Article 12(5) of the treaty

Our comments

In the past, there have been many amendments in the Act expanding the scope of source-based taxation of payments to the non-residents such as software payment, equipment royalty, payment for satellite transmission. Though the Revenue has been arguing that such payments become taxable after the amendments, the Courts have been upholding the non-taxability of such payments in the absence of a similar amendment in the applicable tax treaty.

The Tribunal in the instant case followed the same approach while dealing with the taxability of the interest payment by a PE to its overseas HO.



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