

TAX FLASH NEWS

24 June 2022



Interest income is not attributable to a PE in India under the India-Japan tax treaty

Recently, the Mumbai Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Marubeni Corporation, Japan¹ (the taxpayer) held that taxpayer's interest income was not attributable to a Permanent Establishment (PE) in India. Such income was not taxable as business income but it was taxable as interest under the India-Japan tax treaty (the tax treaty). Mere existence of a PE in the source jurisdiction is not sufficient to invoke taxability of interest income under the interest article unless such income is directly or indirectly attributable to such a PE. Interest income can be said to be effectively connected with a PE only when the connection is such that it leads to taxability in the hands of the taxpayer under the business income article.

Facts of the case

- The taxpayer is a company incorporated in, and fiscally domiciled in, Japan.
- It has various streams of income from its India operations, income from its PE in India, Fees from Technical Services (FTS), income from shipping business and income from interest on suppliers' credit apart from other incidental incomes.
- During the Assessment Year (AY) 2016-17, the taxpayer received interest from its Indian customer on suppliers' credit.
- This interest income was offered to tax at the rate of 10 per cent as interest under Article 11(2) of the tax treaty.
- The Assessing Officer (AO) observed that the taxpayer had a PE in India and hence interest income was taxable as business income under Article 7 at 40 per cent.

- Further the taxpayer was no longer eligible for the concessional rate of gross basis taxation at 10 per cent.
- However, the Commissioner of Income-tax (Appeals) [CIT(A)] held that the interest income was required to be taxed at 10 per cent in terms of the provisions of the Article 11(2) as there was no connection between the interest income and the PE.

Tribunal decision

- Mere existence of a PE in the source jurisdiction cannot be reason enough to invoke the taxability of interest income under the business income Article unless such an income is directly or indirectly attributable to such a PE.
- A connection per se of an income with the PE cannot always and inevitably lead to the attribution of such income in the hands of the PE.
- 'Attribution of an income' to the PE is a degree higher than mere 'connection of an income with the PE.'
- There can be an income which may have some connection with the PE and yet the connection may not be material enough to hold that such an income was attributable to that PE.
- The exclusion clause under the interest Article² does not explicitly provide for taxation of such income at a rate higher than the rate prescribed under the interest Article³.

¹ Article 11(6)

² Article 11(2)

¹ DCIT v. Marubeni Corporation, Japan (ITA No.: 10/Mum/2022) (Mum) - Taxsutra

- It provides that in a situation in which the interest is 'effectively connected' with a PE or a fixed base, the provision of business income or IPS will come into play.
- An interpretation of the exclusion clause making it meaningless will result in an interpretation contrary to the well-settled principle of interpretation *ut res magis valeat quam pereat*, i.e., to make a legal provision workable rather than redundant. This principle has been approved by the Supreme Court in the case of Tinsukhia Electricity Supply Co Ltd⁴.
- The scheme of the exclusion clause does not visualise a situation in which:
 - the source jurisdiction taxability of an interest income⁵ will be ousted because of the enterprise having a PE in the source jurisdiction; and
 - such an interest income will also not be taxable under the business income article as the interest income is not attributable to the PE or under IPS Article as the interest income is not attributable to the fixed base available to the taxpayer.
- Such a no man's land between the domain of Article 11(2) vis-à-vis Article 7(1), or between Article 11(2) vis-à-vis Article 14(1) will be an apparent incongruity.
- Therefore, the connotations of the expression 'effectively connected', in respect of Article 11(6) read with Article 7(1), must be such that unless the interest income cannot be held to be 'directly or indirectly attributable to a PE', the taxation of such an interest income, at a rate higher than Article 11(2), does not come into play.
- Therefore, an interest income can be said to be effectively connected with a PE or with a fixed base only when the connection is such that it leads to taxability in the hands of the taxpayer under the business income article or IPS article.
- To term a connection of the interest income with the PE or the fixed base, as 'effectively connected', one has to see whether, by virtue of such a connection, the interest income in question is taxable as an income attributable to the PE or the fixed base in question.
- Unless that taxability comes into play, there cannot be any overlap in the scope of Article 11 vis-à-vis Article 7 or Article 14.
- Further, unless there is such an overlap of the treaty provisions, there was no occasion for exclusion of one of the overlapping treaty provisions by Article 11(6).
- There was not even an effort, on the part of the tax department, to demonstrate the nexus between the PE and the interest income.
- The onus of establishing the 'effective connection' between the debt claim with the PE was on the AO.
- No part of interest income can be said to be directly or indirectly attributable to the Indian PE of the taxpayer.
- The Tribunal upheld the CIT's conclusion that the interest income was taxable at 10 per cent under the interest Article.

Our comments

This decision interprets the exclusion clause under the interest article of the India-Japan tax treaty and highlights that the taxability under the business income article is necessary to fall into such exclusion clause. This decision may help foreign banks/foreign companies earning interest income to demonstrate that unless the interest income is directly or indirectly attributable to the Indian PE, the same cannot be taxable as business income at higher rate.

⁴ Tinsukhia Electricity Supply Co Ltd v. State of Assam [1989] 45 Taxman 29 (SC)

⁵ Under 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

Bengaluru

Embassy Golf Links Business Park,
Pebble Beach, 'B' Block,
1st & 2nd Floor,
Off Intermediate Ring Road, Bengaluru – 560071
Tel: +91 80 6833 5000

Chandigarh

SCO 22-23 (1st Floor),
Sector 8C, Madhya Marg,
Chandigarh – 160 009.
Tel: +91 172 664 4000

Chennai

KRM Towers, Ground Floor,
1, 2 & 3 Floor, Harrington Road,
Chetpet, Chennai – 600 031.
Tel: +91 44 3914 5000

Gurugram

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

Hyderabad

Salarpuria Knowledge City,
6th Floor, Unit 3, Phase III,
Sy No. 83/1, Plot No 2, Serilingampally
Mandal,
Ranga Reddy District,
Hyderabad – 500 081.
Tel: +91 40 6111 6000

Jaipur

Regus Radiant Centre Pvt Ltd.,
Level 6, Jaipur Centre Mall,
B2 By pass Tonk Road,
Jaipur – 302 018.
Tel: +91 141 - 7103224

Kochi

Syama Business Centre,
3rd Floor, NH By Pass Road,
Vytila, Kochi – 682 019.
Tel: +91 484 302 5600

Kolkata

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

Mumbai

2nd Floor, Block T2 (B Wing),
Lodha Excelus, Apollo Mills Compound, N M
Joshi Marg, Mahalaxmi, Mumbai- 400011
Tel: +91 22 3989 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

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

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

Door No. 54-15-18E,
Sai Odyssey,
Gurunanak Nagar Road, NH 5,
Opp. Executive Club, Vijayawada,
Krishna District,
Andhra Pradesh – 520 008.
Tel: +91 0866 669 1000

home.kpmg/in



home.kpmg/in/socialmedia



The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

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

© 2022 KPMG Assurance and Consulting Services LLP, an Indian Limited Liability Partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

This document is meant for e-communication only.