Tax Flash News

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Special Bench ruled on limitations on deductibility of head office expenses under the Act vis-à-vis the treaty

Executive summary

A recent decision in the case of *Mashreq Bank PSC*[1] dealt with the deductibility of the head office (HO) expenses allocated to the Indian branch (which constituted permanent establishment) while computing its taxable profits.

The Revenue argued that such expenses should be allowed to the extent of limitations provided under the Income-tax Act, 1961 (the Act).

However, the Mumbai Special Bench of the Tribunal accepted the taxpayer's position that the limitations under the Act are not applicable unless the business profit article of the treaty makes a specific reference to such limitations.

The decision also clarifies the scope and purpose of the articles dealing with the computation of profits of the permanent establishment and with the elimination of double taxation.

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[1] *Mashreq Bank PSC* v. *DCIT* (ITA No. 1342/Mum/2006)

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Facts of the case

The taxpayer was a banking company and a tax resident of the UAE.

It operated in India through its branches which constituted permanent establishment (PE).

During the assessment proceedings for the assessment year (AY) 2002-03, the tax officer disallowed a portion of the HO expenditure allocated to the PE, arguing that such expenses were allowable only up to the limitations specified under the Act[2] which is 5 per cent of the average adjusted total income.

Relevant treaty provisions

The business profit article (Article 7(3)) of the India-UAE Tax Treaty (the Treaty) was amended in 2007 (effective from 1 April 2008).

Prior to the amendment, the article provided that all expenses incurred for the purposes of the PE business, whether incurred in the PE state or elsewhere, were allowable as a deduction while computing the PE profits.

[2] Section 44C of the Act

There was no reference to the limitations/ restrictions imposed under the Act on the deductibility of the expenses.

After the amendment, the article additionally provides that such a deduction shall be allowed in accordance with the provisions of, and subject to the limitations of, the Act.

Separately, Article 25(1) of the Treaty dealing with elimination of double taxation provided that the domestic law shall continue to govern the taxation of income except where express provisions to the contrary are made in the Treaty. This article was not amended in 2007 and remained the same before as well as after the amendment.

Taxpayer's contentions

As per the Treaty[3], expenses incurred for the purposes of the PE's business, including HO overhead allocations, are deductible. Such a deduction was not subject to the limitations provided under the Act.

[3] Article 7(3) of the Treaty

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Since the assessment year in question was 2002-03, the pre-amended Treaty was applicable which did not include a reference to the limitations on expense deductions as outlined in the Act. If these limitations were considered as part of the Treaty even for the years before the amendment, the amendment itself would have been unnecessary.

The Treaty merely specifies which expenses should be allocated to the PE for the purposes of calculating the profit attributable to it. It does not address whether these expenses, once allocated, can be deducted when calculating the PE's taxable income. The conditions for the expense deductibility are governed by the Act (subject to the Treaty's non-discrimination clause).

Revenue's contentions

By virtue of Article 25(1) of the Treaty, the limitations on the expense deductions provided under the Act was applicable in the absence of any express provision in the treaty denying or excluding the application of such limitations.

The Treaty does not permit an unrestricted deduction of the HO expenses. If the provisions of the Act are not applied in computing the taxable income, it could lead to unreasonable outcomes allowing all expenses as deduction regardless of whether they are capital or revenue in nature, or whether or not the tax has been withheld.

Decision

Article 7 of the pre-amended Treaty did not impose any restrictions on the allowability of expenditures, nor did it mention the applicability of the Act while computing the PE profits. In the absence of any explicit restriction in the Treaty, the limitations outlined in the Act cannot be read into the Treaty.

If the Revenue's argument were accepted, there would have been no need to amend the Treaty to include reference to the provision of the Act regarding expense allowability. Thus, prior to the amendment, the Treaty was intended to permit the deduction of all expenses without applying the restrictions under the Act.

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The Revenue's argument that the amendment was merely clarificatory in nature was also not acceptable. The amendment was explicitly made effective from 1 April 2008, and without any indication of retroactive application, such an intention cannot be assumed.

Referring to the Supreme Court decision in the case of *Azadi Bachao*[4], the Tribunal reiterated that the treaties are negotiated at political level, and the acceptability and duration of treaty shopping fall under the discretion of the executive. The treaty should be interpreted strictly in accordance with the language used therein.

A comparative analysis of the treaties India has entered into with various countries indicates that whenever there was an intention to apply the restrictions outlined in the Act, it was explicitly stated in the respective treaties, as seen in treaties with the UK and Germany.

In 2007, India and the UAE agreed to limit the expenses allowable when calculating the profits of a PE, aligning with the Act and similar provisions in treaties India has with other countries. The concept of 'reverse discrimination' was not applicable in this case, as the provision of the Act concerning the allowability of HO expenses applies exclusively to non-residents.

As per Article 25 of the Treaty, if there is an express provision in the treaty giving benefit to the taxpayer, which is contrary to the provision of the Act, the treaty provision would override the provision of the Act, to the extent it is more beneficial to the treaty. Such an interpretation of Article 25 aligned with section 90(2) of the Act which also allowed the taxpayer to apply either the provisions of the Act or the treaty, depending on which is more beneficial to it.

The contextual interpretation of Article 25(1) indicates that it provides the mechanism for elimination of double taxation in respect of various sources of income. Whether a particular income is taxable or exempt is determined under the Act unless the treaty specifies otherwise. Treaties typically has specific provisions dealing with the taxation of dividends, royalties etc. followed by a residual clause dealing with 'other income'.

The purpose of Article 25 is restricted to eliminating double taxation either through credit or exemption in the country of residence. Its purpose cannot be expanded to impose restrictions on the manner of computing income or tax which is beyond the scope of elimination of double taxation.

[4] *UOI* v. *Azadi Bachao Andolan* [2003] 263 ITR 706 (SC)

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Article 7(3) lays down the mechanism to compute the PE profit, while Article 25 deals with the elimination of double taxation. Each article applies to different situations.

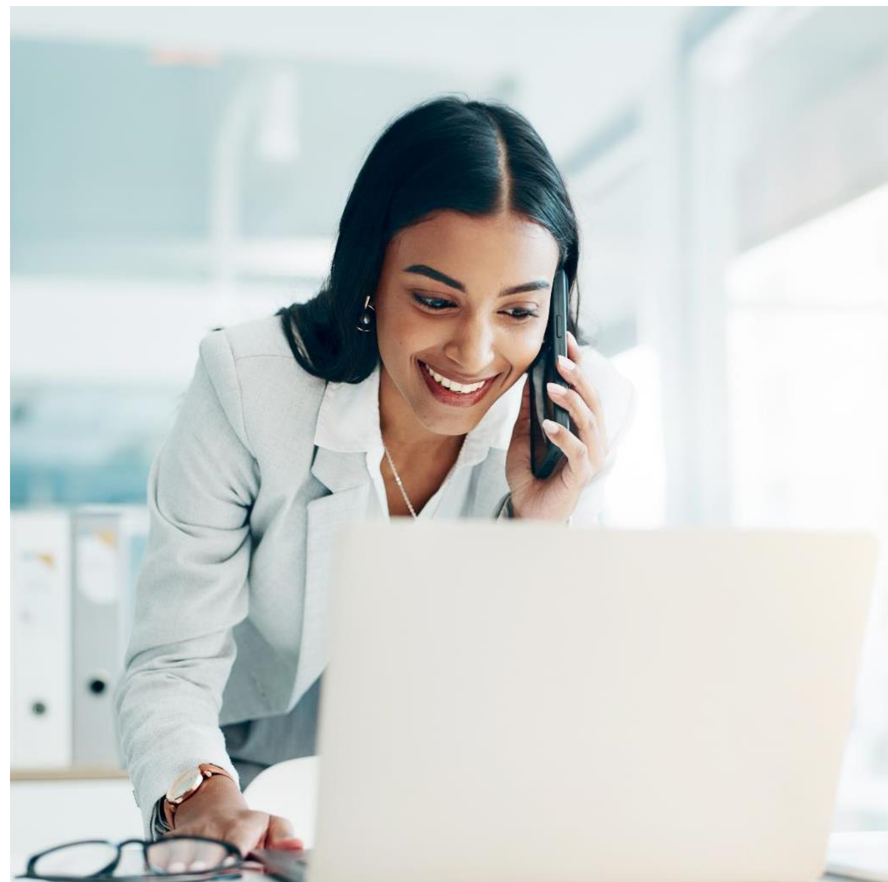
Our comments

The decision addressed the interaction between various provisions within the treaty itself and between the treaty and the Act.

The Tribunal ruled that unless the relevant treaty explicitly incorporates a reference to the limitations outlined in the Act regarding expense deductibility, such limitations cannot be inferred into the treaty.

The India-UAE treaty was amended, effective from 1 April 2008, to include such a reference, meaning the decision may not apply to years following the amendment.

However, some Indian treaties, like the India-Japan tax treaty, still do not refer to the limitations on expense deductibility under the Act, so the decision may continue to be relevant for such treaties.



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