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TAX FLASH NEWS

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The Mumbai Tribunal decision on the allowability of foreign tax credit

Recently, the Mumbai Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Tata Consultancy Services Ltd.[1] (the taxpayer) held that state taxes paid in foreign countries cannot be disallowed under Section 40(a)(ii) of the Income-tax Act, 1961 (the Act), if the same are not eligible for relief under Section 90 or 91 of the Act.

With respect to the foreign tax credit relating to income which is exempt in India, the Tribunal observed that the taxpayer would be eligible to avail tax credit under Section 91 of the Act if India does not have any tax treaty with such country. Where the respective tax treaty provides for a specific tax credit benefit even in respect of income on which the tax has not been paid in India, the taxpayer would be eligible for tax credit under Section 90 of the Act. However, certain tax treaties do not provide for such benefit unless the income is subjected to tax in both the countries. Accordingly, the Tribunal directed the Assessing Officer (AO) to grant credit to the taxpayer.

Facts of the case

The taxpayer, an Indian company, is engaged in the business of export of computer software, providing e-Solutions, Business Process Outsourcing (BPO) activities and other management consultancy activities. The taxpayer has several overseas branches across the globe which are its Associated Enterprises (AEs). For the Assessment Year (AY) under consideration, the taxpayer filed its return of income under the normal provisions of the Act after claiming deduction under Section 10A/10AA of the Act. Further, the taxpayer also declared a book profit under Section 115JB of the Act. Subsequently, the taxpayer filed a revised return of income enhancing the claim of TDS.

[1] Tata Consultancy Service Ltd. v. ACIT (ITA no. 5713/Mum/2016) – Taxsutra.com

Deduction of State taxes paid overseas

During the assessment proceedings, the Assessing Officer (AO) noticed that the taxpayer had claimed deduction of state taxes paid in USA and Canada. However, in taxpayer's own case, in AY 2005-06, the Tribunal while referring to the decision in the case of Tata Sons Ltd[2] held that state taxes paid overseas cannot be allowed as deduction in view of provisions of Section 40(a)(ii) of the Act.

The taxpayer contended that the state taxes paid in USA and Canada do not come within the purview of Section 40(a)(ii). The term 'tax' as defined under Section 2(43) of the Act, would mean the tax chargeable under the Act. Further, in respect of state taxes paid, it is not eligible for any relief either under Section 90 or 91 of the Act read with the applicable tax treaty. Thus, deduction claimed by the taxpayer was not disallowable under Section 40(a)(ii) of the Act.

Tribunal' decision

The Tribunal observed that on perusal of provisions of Section 2(43) of the Act, it becomes clear that the term 'tax' has been defined to mean any tax paid under the provisions of the Act. Section 40(a)(ii) of the Act says that any rate or taxes levied on the profits or gain in any business or profession would not be allowable as deduction. Explanation 1 to Section 40(a)(ii) of the Act inserted by the Finance Act, 2006 with effect from 1 April 2006, further clarifies that any sum eligible for relief of tax either under Section 90 or 91 of the Act would not be allowable as deduction under section 40(a)(ii) of the Act. The taxpayer contended that the tax eligible for relief under Section 90 of the Act is only those taxes which are levied by Federal/Central Government and not by any local authority of State, City or Country. This contention can be accepted if one has to strictly go by the meaning of 'tax', defined under Section 2(43) of the Act, as it only refers to tax paid under the provisions of the Act.

[2] DCIT v. Tata Sons Ltd. [2011] 43 SOT 27 (Mum)

Also, the legal position of the taxpayer's own case in AY 2005-06 has changed after the decision of High Court in case of Reliance Infrastructure Ltd[3]. In the aforesaid High Court decision while interpreting the provisions of Section 2(43) of the Act, vis–a–vis Section 40(a)(ii) of the Act. The Court held that the tax which has been paid abroad would not be covered within the meaning of Section 40(a)(ii) of the Act, since, the meaning of the word 'tax' as defined under Section 2(43) of the Act would mean only the tax chargeable under the Act. Thus, relying on the High Court decision taxes levied overseas which are not eligible for relief either under Section 90 or 91 of the Act, would not come within the purview of Section 40(a)(ii) of the Act.

The Tribunal directed the AO to verify whether the State taxes paid by the taxpayer overseas are eligible for any relief under Section 90 of the Act and if the taxpayer is not eligible for the same, the taxpayer's claim of deduction should be allowed.

FTC in respect of income pertaining to section 10A/10AA units

In the course of assessment proceedings, the taxpayer had furnished country wise statement of tax paid in support of its claim of tax credit under Section 90 and 91 of the Act. The AO allowed tax credit in respect of tax paid overseas on the income which was not only offered to tax abroad but was also subjected to tax in India to the extent not exceeding the rate of tax payable in India. However, in respect of income subjected to tax abroad but exempt from payment of tax in India, the AO did not grant relief either under Section 90 or 91 of the Act. Further, the CIT(A)relying on the decision of the High Court in case of Wipro Ltd.1, bifurcated the foreign tax credit into three parts i.e., tax paid in USA, tax paid in other tax treaty countries and tax paid in non–tax treaty countries. Thereafter, CIT(A) directed the AO to allow tax credit in respect of tax paid in USA even on the income which is exempt from tax in India under Section 10A/10AA of the Act. However, in respect of tax paid in other cases, no tax credit was allowed in respect of income which is exempt from tax in India under Section 10A/10AA of the Act.

Tribunal's decision

The Tribunal observed that in the decision of Wipro Ltd., the High Court while dealing with an identical issue held that in the cases covered under Section 90(1)(a)(ii) of the Act, it is not the case of income being subjected to tax or the taxpayer has paid tax on the income. The provision applies to a case where the income of the taxpayer is eligible to tax under the Act as well as in the corresponding law in force in the other country. Further, though the income tax is chargeable under the Act, it is open to the Parliament to grant exemption under the Act from payment of tax for any specified period, normally, to incentivize the taxpayer to carry on manufacturing activities or providing services. With regard to countries with which India does not have any agreement for avoidance of double taxation, the High Court observed that as per Section 91 of the Act, the taxpayer would be eligible to avail tax credit. Thus, the Tribunal observed that where the respective tax treaty provides for benefit for foreign tax paid even in respect of income on which the taxpayer has not paid tax in India, still, it would be eligible for tax credit under Section 90 of the Act. Thus, as per Article 25 of the Indo–USA treaty benefit of foreign tax credit can be availed even in respect of income not subjected to tax in India. However, India–Canada, Finland treaties do not provide for such benefit unless the income is subjected to tax in both the countries. Therefore, the foreign tax credit would be available to the taxpayer in all cases except the foreign tax paid in Finland and Canada. The Tribunal directed the AO to grant credit accordingly.

Disallowance of expenditure incurred for purchase of software

During the assessment proceedings, the AO noticed that the taxpayer had claimed expenditure incurred for purchase of software. The AO found that the taxpayer had purchased software for its internal use and for trading purpose. The AO observed that the amount paid towards acquiring software brought along with support service was in the nature of royalty as per Section 9(i)(vi) of the Act. Since the taxpayer had not deducted tax at source, the amount paid towards acquiring software was liable for disallowance under Section 40(a)(i) of the Act. Further the Commissioner of Income-tax (Appeals) [CIT(A)] following the order passed by the Tribunal in taxpayer's own case for the AY 2005–06, held that the expenditure incurred on software products acquired for internal use is a capital expenditure, hence, the taxpayer was entitled to depreciation thereon. However, for the payment made towards software products acquired for re-sale the CIT(A) observed that it was in the nature of royalty. In the Tribunal's own case1 , the Tribunal had held that the expenditure incurred for acquiring software for trading purpose was not in the nature of royalty, as the payment made was for acquiring a copyrighted article and not transfer of any right in a copyright.

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[3] Reliance Infrastructure Ltd. v. CIT [2017] 390 ITR 271 (Bom)
[4] Wipro Ltd v. DCIT [2015] 62 taxmann.com 26 (Kar)

Tribunal' decision

The Tribunal, with respect to the payment made towards acquiring software for internal use observed that the taxpayer had acquired assets of enduring benefits and thus, held that such payment was capital in nature and the taxpayer was entitled to depreciation on the cost of such assets. Further, for payment made towards acquiring the software for re-sale the Tribunal observed that the AO had not at all deliberated on the factual aspect whereas, the CIT(A) had observed that the software products acquired by the taxpayer cannot be sold independently and can be sold by utilising in the package developed by it and thus it falls within the scope of royalty. However, the taxpayer contended that the software was acquired for the purpose of trading and is a copyrighted article and it was sold to the customers as it is. Thus, the Tribunal directed the AO to factually verify the nature of transaction relating to acquisition of software product for trading purpose and to find out whether it was a sale of copyrighted article simpliciter or sale of copyright.

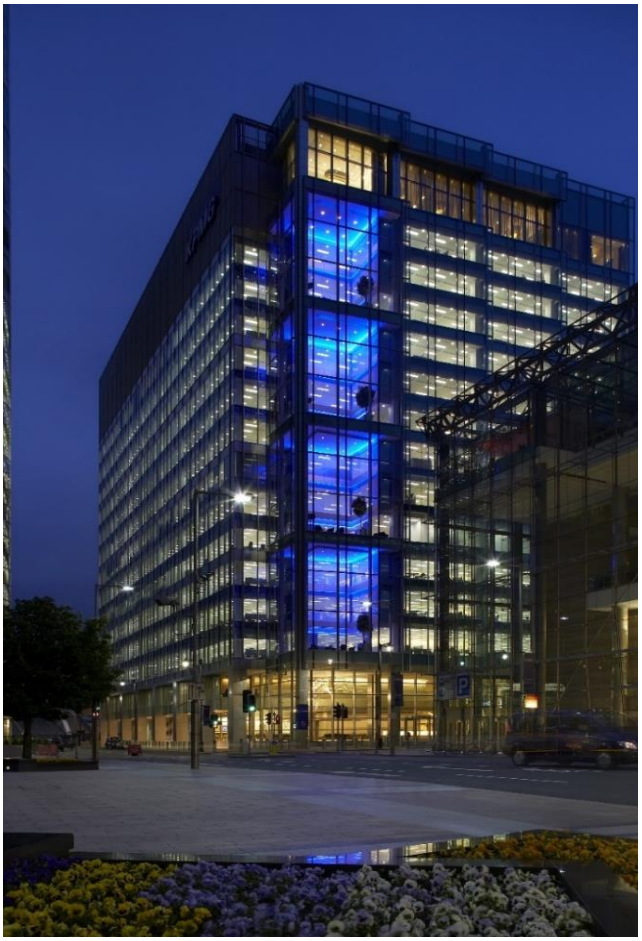
Our comments

The issue of allowability of FTC has been a matter of debate before the courts. The Mumbai Tribunal in the case of Blue Star Infotech Ltd[6] directed the tax officer to allow credit of foreign tax paid in Japan against tax levied on corresponding income eligible for deduction under Section 10B of the Act in India.

With respect to the foreign tax credit relating to income which is exempt in India, the Tribunal observed that the taxpayer would be eligible to avail tax credit under Section 91 of the Act if India does not have any tax treaty with such country. Where the respective tax treaty provides for a specific tax credit benefit even in respect of income on which the tax has not been paid in India, the taxpayer would be eligible for tax credit under Section 90 of the Act[7]. However, certain tax treaties[8] do not provide for such benefit unless the income is subjected to tax in both the countries. Accordingly, the Tribunal directed the AO to grant credit to the taxpayer.

Further the Tribunal held that state taxes paid in foreign countries cannot be disallowed under Section 40(a)(ii) of the Act, if the same are not eligible for relief under Section 90 or 91 of the Act.

It is important to note that the Ahmedabad Tribunal in the case of Dr. Rajiv I. Modi[8] held that a taxpayer was entitled to credit in respect of state income taxes paid in the USA relying upon Section 91 of the Act. This was held in spite of the fact that the case pertained to a country (USA) which has a tax treaty with India, and to which Section 90 of the Act applies.



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[5] Blue Star Infotech Ltd v. ACIT [2015] 154 ITD 81 (Mum)
[6] India–USA, Denmark, Hungary, Norway, Oman, Saudi Arabia, Taiwan, etc. tax treaty
[7] India-Canada, Finland tax treaty
[8] Dr. Rajiv I. Modi v. DCIT (ITA No. 1285 [AHD] 2014, dated 21 September 2017)

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