Tax Flash News

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Taxation of a foreign company at a higher rate is not prevented by non-discrimination article of the tax treaty

Executive summary

The corporate tax rate applicable to a foreign company is higher than that applicable to a domestic company under the Income-tax Act, 1961 (the Act).

The foreign banking companies with branch in India have been arguing that the taxability at such higher rate is impermissible as per the non-discrimination article (NDA) of the tax treaty, and they should be taxable at a rate applicable to the domestic companies.

The Calcutta High Court in the case of *The Royal Bank of Scotland N.V.*[1] held that the taxation of a foreign company at a rate higher than that applicable to a domestic company is not prevented by the NDA of the India-Netherlands tax treaty (the treaty).

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[1] *The Royal Bank of Scotland N.V.* v. *CIT* (ITA/155/2005) (Cal) - Source: Taxsutra

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Facts of the case

The taxpayer (a resident of the Netherlands) was a foreign company for the purposes of the Act.

In India, the taxpayer had a branch which was registered as a scheduled bank in terms of the Reserve Bank of India Act, 1934.

The branch qualified as a permanent establishment (PE) in India and the taxpayer was liable to tax in India in respect of the income attributable to the PE.

The issue arose whether the tax rate applicable to the taxpayer could be the rate applicable to a domestic company even when it is a foreign company, in view of the NDA under the treaty.

Relevant provisions

A domestic company has been defined in the Act[2] to mean (a) an Indian company, or (b) any other company which, in respect of its income liable to tax under the Act, has made the prescribed arrangements for the declaration and payment of the dividends within India payable out of such income (Other Company).

A foreign company is defined to mean a company which is not a domestic company[3].

The Act and the relevant finance act provide for rates applicable to the domestic companies and the foreign companies, and the corporate tax rate applicable to a foreign company is higher than that applicable to a domestic company.

As per the NDA under the treaty[4], the taxation on a PE of the Netherlands' enterprise in India should not be less favourably levied than the taxation levied on the Indian enterprise carrying on the same activities.

Explanation 1 to section 90 of the Act provides that the charge of tax at a higher rate on a foreign company as compared to a domestic company shall not be regarded as less favourable charge in respect of the foreign company. The Explanation was introduced by the Finance Act, 2001 w.r.e.f. 1 April 1962 and its wordings suggest that it is clarificatory in nature.

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[2] Section 2(22A) of the Act
[3] Section 2(23A) of the Act
[4] Article 24(2) of the treaty

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Taxpayer's arguments

The NDA must be construed as specifically imposing a bar on either of the treaty countries from levying tax at a rate higher than that applicable to a domestic enterprise[5]. Accordingly, the taxpayer should be liable to tax at the rate applicable to a domestic company.

A unilateral amendment in the Act (the Explanation) cannot override the treaty provisions. Rather, a specific treaty provision prevails over the general provisions of the Act, as per the CBDT Circular no. 333 dated 2 April 1982.

The Explanation is not clarificatory in nature as it seeks to enlarge the levy of tax by effectively taking away the benefit provided by the NDA.

Where the legislature wanted to enact a provision that would override a treaty provision, specific language (non-obstante clause) to that effect had been used. For instance, section 90(2A) which deals with the inter-play between the domestic GAAR and the treaty provisions. There is no such language used in the Explanation.

Other provisions of the treaty were amended even after the insertion of the Explanation, but no corresponding amendment was made in the NDA of the treaty.

The NDA in the tax treaties with Tanzania, Sri Lanka and New Zealand was amended to provide that India is not prevented from charging the profits of a PE of a foreign company at a tax rate higher than that imposed on the profits of a similar Indian company. No such amendment was made in the India-Netherlands tax treaty.

The Explanation only refers to domestic companies and does not refer to the co-operative societies. The taxpayer, who is carrying on similar activities and are subject to similar regulations as a co-operative bank, cannot be taxed at a rate that is less favourable than the rate applicable to a co-operative society engaged in the business of banking.

[5] *Bank of Tokyo Mitsubishi Ltd.* v. *CIT* [2019] 108 taxmann.com 242 (Cal)

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High Court's decision

For the purposes of providing the tax rates, each year, the finance act classifies the companies in two categories – domestic companies and companies other than domestic companies (i.e., foreign companies) and such a classification is valid[6] .

The NDA prevents a less favourable levy between two enterprises falling under one and the same class and not between two enterprises falling under different classes.

Accordingly, the tax on a company falling under 'Other Company' category shall not be less favourably levied than on an 'Indian company', as both the companies fall under one and the same class i.e., domestic company.

The taxpayer is not covered by any of these two categories of domestic company and is a foreign company.

The above-mentioned provisions existed even prior to the treaty entering into force or the insertion of the Explanation.

The Explanation merely reiterated the clear statutory provisions for the rate of tax and is clarificatory in nature. This is also evident from the wordings of the Explanation and the explanatory notes on the provisions of the Finance Act, 2001 which inserted the Explanation in section 90.

Even in the absence of the Explanation, the statutory provision for the rate of tax applicable to the foreign companies remained clear at all relevant point of time.

Circular no. 333 provides that a specific provision in the treaty will prevail over the general provision of the Act. Further, the circular also states that the treaty provides that the domestic law will continue to govern the assessment and taxation of income except where the treaty contains a contrary provision.

However, in the instant case, there is no specific provision in the treaty providing the tax rate applicable to a domestic company or a foreign company as defined in the Act. Also, there is no conflict between the NDA and the provisions of the Act. Accordingly, the circular is of no help to the taxpayer.

[6] *Amalgamated Tea Estates Co. Ltd.* v. *State of Kerala* (1974) 4 SCC 415

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