

TAX FLASH NEWS

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Since interest on income-tax refund is not effectively connected with a PE, it is taxable at a concessional rate as per the interest article under the India-USA tax treaty

Executive Summary

Recently, the Delhi Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Transocean Offshore International Ventures Ltd.¹ (the taxpayer) dealt with the issue of taxability of interest on income tax refund under the India-US tax treaty (tax treaty). The Tribunal observed that interest on an income tax refund is not effectively connected with the Permanent Establishment (PE) either on the basis of asset-test or activity-test. Accordingly, it is taxable under the interest article [Article 11(2)] of the tax treaty at a beneficial rate.

Facts of the case

The taxpayer, a tax resident of U.S. had received interest on income tax refund during the Assessment Year 2012-13. The Assessing Officer (AO) held that such interest income received by the taxpayer was taxable at 40 per cent.

The taxpayer contended that the interest received on the income-tax refund was chargeable to tax under Article 11 of the tax treaty. However, the tax department contended that the taxpayer was carrying on business through its Permanent Establishment (PE) and thus, it was right in taxing the interest income as business income.

Tribunal's decision

As per the provisions of Section 90(2) of the Income-tax Act, 1961 (the Act), in a case where the provisions of the tax treaty applied to the taxpayer, the provisions of the

Act should apply to the extent they were more beneficial to the taxpayer. Although the words 'more beneficial' has not been elaborated upon by any of the contending parties, it is clear that application of the provision can be made after ascertaining (i) tax payable by the taxpayer under the tax treaty and (ii) tax payable by the taxpayer under the Act.

If the tax payable under the Act was lesser than the tax payable under the tax treaty, it could be concluded that the provisions of the Act were more beneficial to the taxpayer. However, if the tax payable by the taxpayer under the tax treaty is lesser than the tax payable under the Act, the taxpayer shall have the benefit of the tax treaty.

If we compute the taxpayer's income under the head 'other sources', the net income by way of interest received from the income-tax department shall amount to INR 1.75 million. This amount will be taxed at the rate applicable to a foreign company, which is more than the rate applicable to interest under a tax treaty. Therefore, on making the assessment of tax under the tax treaty, the applicability of the tax treaty is more beneficial to the taxpayer.

No other consideration was material for this purpose as ultimately, what is to be seen is whether the provisions of the Act are more beneficial to the taxpayer or not.

The Tribunal held that interest on income tax refund was not effectively connected with the PE either on the basis of asset-test or activity-test. Hence, it was taxable as per the provisions of Article 11(2) of the tax treaty.

Interest income need not be necessarily business income in nature for establishing the effective connection with the PE because that would render provision contained in Article 11(4) redundant. Thus, there may be cases where interest may be taxable under the Act under the residuary head and yet be effectively

¹ Transocean Offshore International Ventures Ltd. v. DCIT (ITA No. 5895/DEL/2017) – Taxsutra.com

Note: The Tribunal has dealt with several issues in this decision. However, this flash news deals with the issue with respect to the taxability of interest on income tax refund under the tax treaty

connected with the PE. The bank interest in this case is an example of an effective connection between the PE and the income as the indebtedness is closely connected with the funds of the PE.

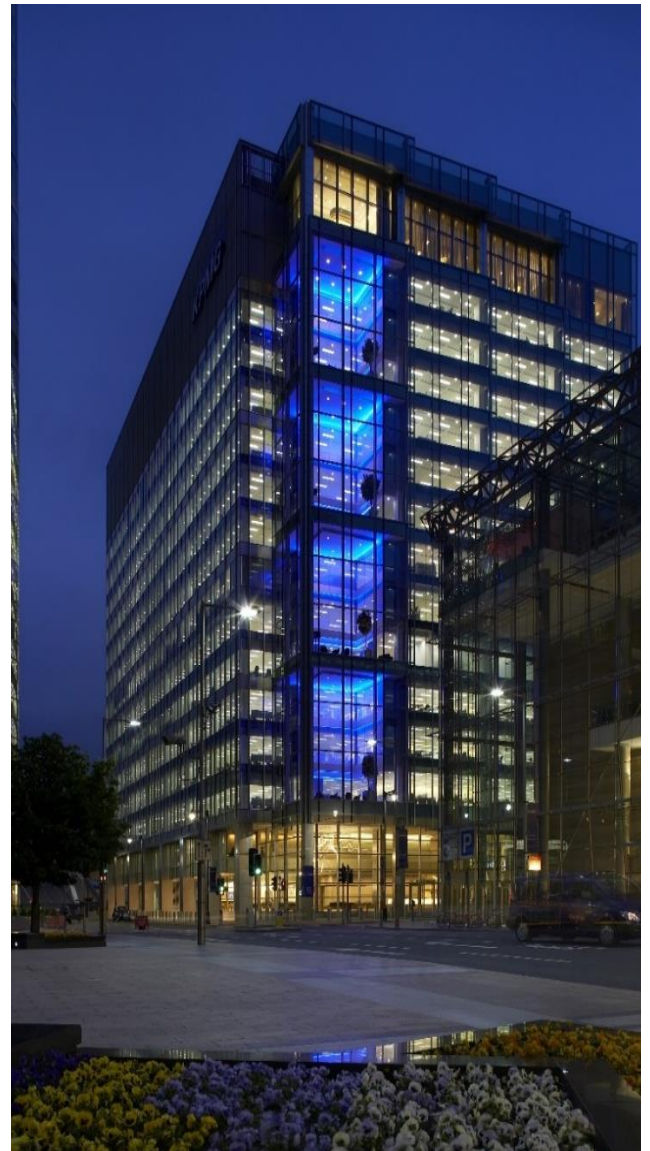
However, in the instant case, it was held that interest on an income tax refund is not effectively connected with the PE. Consequently, it is taxable under the provisions of Article 11(2) of the tax treaty as interest income.

Our comments

Taxability of interest on income tax refund has been a subject matter of debate before the Courts/Tribunal.

It has been held in some of the decisions² that interest income earned by a foreign tax resident; on refund of tax dues could not be treated as business income under a tax treaty as such refund was not effectively connected with the Indian PE of the taxpayer. Accordingly, such interest was taxable at a concessional rate under the interest article of the respective tax treaty.

On the similar lines, the Tribunal in the present case has held that since interest on income-tax refund is not effectively connected with a PE, it is taxable at a concessional rate as per the interest article under the tax treaty



² ACIT v. Clough Engineering Ltd [2011] 11 taxmann.com 70 (Del) (SB), Bechtel International Inc., USA v. ADIT (ITA No. 4129/Mum/2007 and ITA No. 2188/Mum/2010), International Global Networks B.V. v. DDIT [2012] 50 SOT 433 (Mum)

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