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Sharp Insights

In the case of Standard Chartered Grindlays Pty Ltd. (ITA No. 3578/Del/2013), the Delhi Tribunal held that interest on monies borrowed by the Indian branch from its head office outside India is not a tax deductible expense both under the domestic tax law as well as under India-UK Double Taxation Avoidance Agreement

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Background

- Standard Chartered Grindlays Pty Ltd. ('taxpayer') is a banking company incorporated in UK.
- The taxpayer carried on banking and other related activities in accordance with the provisions of the Banking Regulation Act 1949 through its network of branches in India.
- The taxpayer filed its return of income in India based on which assessment was formed in which several additions were made.
- On appeal, the Tribunal set aside the issue regarding deductibility of interest paid by Indian branch/permanent establishment ('PE') to its head office ('HO') to the tax officer ('TO') for adjudication after ascertaining the correct facts.
- The TO while giving effect to the order of ITAT, disallowed interest paid by the PE in India to its HO.
- On appeal, the CIT(A) upheld the disallowance of interest paid by the PE to its HO. The CIT(A) also did not accept the other contentions of the taxpayer i.e. time limitation for giving appeal effect, interest charged under section 244A and section 220(2) of the Act.
- The tax payer filed an appeal before the Tribunal.

Ruling of the Tribunal

Assessment order time barred

- The taxpayer argued that the Tribunal had set aside the matter to the TO on 18 August 2006, for fresh adjudication and the order was passed on 3 December 2010, much after the prescribed time limit of 9 months as per the second proviso to section 153(2A) of the Act. Therefore, the order was barred by limitation and bad in law.
- Further, the taxpayer argued that the CIT(A) erred in interpreting that the limitation period of 9 months is restricted only to cases when the entire assessment is set aside by the Tribunal.
- The Tribunal, after going through the decisions cited by the taxpayer and the TO held that the limitation of 9 months provided in the second proviso to section 153(2A) would apply only when the entire assessment is set aside or cancelled in order to give effect to the findings and directions of the appellate authority. Thus, the Tribunal held that in the present case, the entire assessment order was not set aside but only one of the issues in relation to deductibility of interest paid by PE to the HO was set aside and thereby, the Tribunal concurred with the findings of the CIT(A).

Deductibility of interest paid by PE to HO

- The PE had borrowed funds from its HO, ANZ Grindlays London UK, and paid interest at LIBOR as per the directions of the Reserve Bank of India ('RBI').

- The interest paid to the HO was claimed as deduction in computation of business income, in accordance with Article 7(7) of the double tax avoidance agreement ('DTAA') between India and UK. Article 7(7) provides that payments made by a PE to the HO of the enterprise such as royalties, fees, etc. are not deductible except, interest paid to HO on monies lent to the PE of a banking enterprise. Thus, the tax payer argued that Article 7(7) of the DTAA specifically permits deductibility of interest paid by the PE of a banking company to its HO for monies borrowed for the business of the PE. The tax payer placed reliance on various judicial pronouncements including the Special Bench decision in the case of Sumitomo Banking Corporation (16 ITR (AT) 116) (Mumbai Tribunal) and ABN Amro Bank v. DDIT (343 ITR 81) (Kolkata HC).
- The Tribunal distinguished the decision in the case of Sumitomo Banking Corporation stating that in that case the applicable DTAA was India-Japan and in the taxpayer's case the applicable DTAA is India-UK. It concurred with the difference in the DTAAs as pointed out by the CIT(A) i.e. as per Article 7(3) of India-Japan DTAA, deduction of expenses is allowable and there is no restriction. However, as per Article 7(5) of the India-UK DTAA these deductions shall be subject to limitations of the domestic tax law of the contracting state in which the PE is situated.
- The Tribunal observed that Article 7(7) contains an exception, as per which Article 7(5) shall not apply to certain amount paid by PE to HO. However, there is an exception as per which in case of a banking enterprise, interest shall be subject to provision of Article 7(5) and therefore subject to provisions of the domestic tax law.
- Under the Indian tax law, interest paid by the PE to HO is treated as payment to self and thereby not deductible. Therefore, the Tribunal upheld the view of the CIT(A) that interest paid by PE to HO on money lent shall not be allowed as deduction under the Act or in accordance with provisions of Article 7(5) read with Article 7(7) of India-UK DTAA.
- The Tribunal also distinguished the decision in the case of ABN Amro Bank stating that it is not applicable in the case of the taxpayer as the issue in the said decision was whether interest paid by PE to its HO, which is otherwise deductible, is subject to withholding tax and hence not allowable as deduction under section 40(a)(i) read with section 195 of the Act, whereas in the present case the issue involved is as to whether interest paid by the PE to HO is per se tax deductible or not.
- The taxpayer argued that any interest paid by the PE to its HO on account of a foreign currency deposit in India falls within the ambit of section 10(15)(iv)(fa) of the Act and hence such interest is exempt from withholding tax. Taxpayer clarified that placements of funds with National Housing Bank ('NHB') constitute deposit as understood in banking laws. Also, the funds were brought into India in explicit compliance with a directive issued by the RBI under the Banking Regulation Act, 1949.
- The Tribunal rejected the argument of the taxpayer and held that there are two basic pre-conditions for applicability of section 10(15)(iv)(fa) of the Act – firstly, there should be a deposit in foreign currency on which interest is paid by a schedule bank to a non-resident or not ordinarily resident and secondly, such deposit is approved by the RBI.

- The Tribunal concurred with the findings of the CIT(A) and held that the submission of the taxpayer is based on the nature of transaction between PE and NHB whereas according to section 10(15)(iv)(fa), the nature of transaction on which interest is paid to non-resident should be in the nature of deposit in foreign currency. Further, RBI has given directive to the PE for the payments to be made to NHB and not regarding source from which the PE can raise funds. Thus, the Tribunal held that provisions of section 10(15)(iv)(fa) of the Act are not applicable in the case of the taxpayer.

Withdrawal of interest u/s 244A and interest charged u/s 220(2) of the Act

- The taxpayer argued that the TO has wrongly withdrawn the grant of interest under section 244A. It also argued that interest under section 220(2) of the Act was charged without issuance of notice of demand under section 156 of the Act.
- The Tribunal held that withdrawal of grant of interest under section 244A of the Act is consequential in nature and does not need independent adjudication. However, it agreed with the taxpayer's argument that issuance of notice of demand under section 156 of the Act is a pre-condition for levy of interest under section 220(2) of the Act and thereby set aside the matter to the file of the tax officer to examine whether the notice of demand under section 156 was issued or not and decide the matter afresh as per law.

Conclusion

- The Tribunal has concluded that the interest paid on monies borrowed by the PE in India from its HO shall not be allowed as deduction in the hands of the Indian PE under the Act, as well as under the provisions of India-UK DTAA.
- The decision of the Special Bench of Mumbai Tribunal in the case of Sumitomo Banking Corporation, Kolkata HC in the case of ABN Amro Bank and the applicable tax treaty may need to be read in a holistic manner to arrive at a conclusion whether the interest paid by the PE to its HO can be claimed as a deduction.

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