

Tax Hotline

October 14, 2008

NON-DISCRIMINATION STILL AT CROSS ROADS: INDIAN PE OF US COMPANY NOT ENTITLED TO EXPORT INCENTIVES

Navigating through several grey aspects of international tax and constitutional jurisprudence, the Pune Bench of the Income Tax Appellate Tribunal (“ITAT”), in the recent case of *Automated Securities Clearance Inc. v. ITO*¹, held that the Indian branch of a US company was not eligible for deduction of profits derived from the export of software. The decision highlights a number of important issues concerning the scope and application of the non-discrimination clause in the India-US tax treaty to permanent establishments (“PE”).

BACKGROUND

The taxpayer is a US company having a branch office in India which is engaged in the business of exporting computer software. It sought to deduct these profits while computing its Indian tax liability in accordance with section 80HHE² of the Income Tax Act, 1961 (“ITA”), on the grounds that this incentive could be availed of by non-residents carrying on business in India through a PE to the same extent as an Indian company.

Section 80 HHE of the ITA provides an incentive to entities engaged in the export of computer software and related technical services by allowing a deduction of the profits (to a specified extent) derived from such exports provided it has resulted in an inflow of foreign exchange. This incentive however, has been provided only to Indian companies or other persons (not being companies) resident in India. However, a branch of a foreign entity does not have any existence independent from its non-resident parent and would not qualify as a ‘person’ under section 2(31) of the ITA. Consequently, such branch would not be eligible for the export incentives under section 80 HHE of the ITA.

The taxpayer primarily relied on the non-discrimination provision in Article 26(2) of the India-US tax treaty to assert that a PE of a foreign company should be treated on par with Indian companies in matters of eligibility to such allowances and deductions. The said provision states that a PE of a US based enterprise in India shall not be less favorably taxed than Indian enterprises carrying on the same activities. This would apply even in case of incentive deductions like the one provided by section 80HHE, especially having regard to the OECD Commentary on Article 24(3) which provides that the economic incentives conferred by a state should be extended to the PE of an enterprise of another state. Accordingly, an appeal was preferred to the ITAT on the issue of whether the disentanglement of PEs of foreign companies to the benefits under section 80 HHE of the ITA would amount to discrimination in terms of Article 26(2) of the India-US tax treaty.

DECISION OF THE ITAT

The ITAT observed that the Technical Explanation to the US Model Convention was an authoritative statement on the treaty policy of the United States and took precedence over the OECD Commentary in situations of ostensible conflict. On the basis of the said Technical Explanation, the ITAT observed that the term ‘discrimination’ necessarily involved a degree of arbitrariness and hence, any differential treatment that is reasonable could not be construed as discrimination under Article 26 of the India-US Treaty. Invoking the well-established constitutional law principle of intelligible differentia and rational nexus³ the ITAT emphasized that non-discrimination would not exist if there is a coherent relationship between the differential treatment fostered by a treaty provision and the object behind such provision.

It was noted that the object of granting the profit based incentive deduction under Section 80HHE of the ITA is to augment India’s foreign exchange reserves. This incentive has been provided only to Indian residents since, unlike in the case of non-residents, the profits are more likely to be retained and employed within India. In view of this, the ITAT held that the differentiation between residents and non-residents is reasonable. Hence, the exclusion of non-residents from being entitled to the export incentives is not violative of the non-discrimination requirement under Article 26 of the India-US Treaty⁴.

ANALYSIS

There is no doubt that the concept of reasonableness and non-arbitrariness pervades the entire constitutional scheme and is a golden thread running through the whole fabric of the Indian Constitution⁵. These concepts are especially relevant in a case where a High Court of a State or the Supreme Court of India has an occasion to determine the constitutional validity of taxing statutes.

However, assuming that the concept of reasonableness can be read into the non-discrimination clause, it still needs to be seen whether the differentiation created by provisions such as section 80 HHE can truly be regarded as reasonable. The ITAT’s justification of such differentiation on the grounds that it was aimed at augmenting foreign exchange reserves seems to be misplaced in the current economic scenario where the government’s policy for inbound and outbound investments has been considerably liberalized. Further, this judgment like many others in the recent past, also incorrectly dilutes the persuasive value of the OECD Commentary.

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Another important ramification of this decision is that, since PEs of foreign companies do not qualify as a 'person' or a 'resident', it may not be able to use a tax treaty between the source country and a third country in triangular structures. The prospects of using the non-discrimination clause to justify treaty entitlement in such situations could also get significantly eroded.

The decision of the ITAT has apparently ensured that the principle of non-discrimination continues to be stranded on the crossroads of international tax jurisprudence.

- Mahesh Kumar & Parul Jain

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1. ITA No. 1758/PN/2004
 2. The benefits under this section are no longer available.
 3. This principle has its origins in the decision of the Supreme Court of India in State of W.B. v. Anwar Ali Sarkar AIR 1952 SC 75, where it sought to evolve a standard for the constitutional validity of legal provisions against the background of Article 14 of the Indian Constitution.
 4. The ITAT while arriving at the same conclusion reached by the Commissioner (Appeals), rejected the latter's contention that the differentiation is justified in the light of a special carve-out provided in Article 26(2) of the India-US Treaty in respect of additional allowances or reductions provided to residents on the basis of civil status. The ITAT held that this would apply only to individuals and not companies.
 5. Borrowing the words of the Supreme Court in Ajay Hasia v. Khalid Mujib Sehravadi, AIR 1981 SC 487.

Source: *Automated Securities Clearance Inc. v. ITO*, ITA No. 1758/PN/2004

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