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A True Judge Understands Silence of the Tax Treaty better than words

Shilpa Goel (Tax Lawyer) · Thursday, November 15th, 2018

Almost every foreign client I have advised has at some stage told me how complex the Indian Income Tax Act is. And those who follow Indian tax jurisprudence closely know that judicial decisions, in many cases, are doubly complex. Recently, India's Income Tax Appellate Tribunal (ITAT), New Delhi was asked to decide if the tax authority had the power under the Income Tax Act to deny or limit deduction of expenses incurred by an Indian permanent establishment, even if Article 7(3) of the India-Mauritius tax treaty allowed for a full deduction.

The answer to this question is not always simple and requires careful consideration of the domestic and tax treaty law. In this case (*DDIT Intl. Tax vs M/s Unocol Bharat Limited*), the taxpayer is a Mauritian subsidiary of a US parent and was carrying on business activities in India. It is common ground that the taxpayer had a permanent establishment in India.

The dispute arose from the taxpayer's claim, and the tax authority's denial, of deduction of certain expenses incurred by the permanent establishment, particularly salary payments (for seconded employees) and operating contract payments. Why, one may curiously ask?

Well, employee costs were disallowed because the taxpayer did not deduct tax at source while making salary payments to the seconded employees. Operating contract payments were also disallowed for the same reason. According to the tax authority, the Income Tax Act requires the taxpayer to deduct tax at source at the time of making payments, a requirement which the taxpayer did not fulfil and hence is ineligible for the deduction.

In its decision of October 5, the ITAT ultimately ruled in favour of the taxpayer and allowed the deduction. However, the ITAT did not adequately and convincingly reason why it reached that outcome – as it should have.

The main thrust of the ITAT's analysis is that a limitation contained in the Income Tax Act cannot be read into a tax treaty. Of course, that is a difficult proposition to contest, at least in principle. Treaty partners are both under an obligation and a duty to give effect to the provisions of a tax treaty in good faith.

However, it is equally difficult to argue against the proposition that courts should interpret a tax treaty in a manner that gives effect to a tax treaty provision without unnecessarily impinging upon a sovereign country's right to manage and enforce its domestic tax law.

This becomes more important when a tax treaty is silent on a particular subject matter. For instance, Article 7(3) of the India-Mauritius tax treaty states:

"*In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the business of the permanent establishment including executive and administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere*."

A deduction, therefore, should be allowed as long as the expense is incurred "for the purpose of the business of the permanent establishment, including executive and administrative expenses." However, the treaty is silent on whether the deduction should be allowed in accordance with and subject to the limitations of the domestic tax law.

In contrast, this is what Article 7(3) of the India-US tax treaty states:

"*In the determination of the profits of a permanent establishment, there shall be allowed as deductions expenses…in accordance with the provisions of and subject to the limitations of the taxation laws of that State*."

One could well argue that because the India-Mauritius tax treaty does not subject the deduction of expenses to the limitations of the Income Tax Act, the domestic tax law limitation does not apply to the deduction claimed. However, there is a counter-argument and that is that the limitation stipulated in the India-US tax treaty is inserted *ex abudanti coutela*and is merely clarificatory in nature.

Put differently, can we assume that the absence of such a clarification in the India-Mauritius tax treaty means that the treaty is endorsing non-application of domestic tax law? How can we be so sure that the treaty partners never intended to apply the provisions of the domestic tax law to principles governing deduction of expenses? Do several of India's existing tax treaties not subject the deduction of expenses to domestic tax law? Can domestic tax law limitations be ignored unless the tax treaty expressly permits so? What does the OECD Commentary say on this issue?

There can be different answers and explanations, but these are important questions to be engaged with and not to be ignored. That is another reason why we have tax tribunals and courts. Unfortunately, the ITAT did not dwell upon these questions, even peripherally so, and failed to reason its outcomes. Of course, there is considerable force in the taxpayer's argument that the question of deducting tax does not arise in the first place because the employees stayed in India for less than 183 days (in view of Article 15 of the India-Mauritius tax treaty). But giving effect to a tax treaty because domestic tax law cannot put a limitation is entirely different from giving effect to a tax treaty because that limitation does not apply.

Another legit concern with the ITAT's ruling is that it failed to engage with two ITAT decisions given in the past in the *Mashreq Bank Psc*and the *Abu Dhabi Commercial Bank*cases. In *Mashreq Bank Psc*, for instance, the ITAT upheld the domestic tax law limitation on deduction of the expenses noting that tax treaties cannot encourage "reverse discrimination", that is, tax treaties cannot discriminate in favour of non-resident businesses (the idea being that Indian companies will not be allowed deductions if they did not comply with the provisions of the Income Tax Act).

Now, one can point to several provisions in tax treaties and the Income Tax Act that can be said to tilt in favour of non-resident companies. However, can such discrimination exist even where a tax

treaty or the Income Tax Act does not expressly endorse it? Again, one may approach this issue one way or the other. But it is important to at least engage with these issues like the ITAT did in *Mashreq Bank Psc*.

Clearly, this legal reasoning is lacking in the ITAT's October 5 decision. It is not the tax authority's case that the Income Tax Act makes partial a deduction that is otherwise full under the tax treaty. The tax authority's case is that full deduction should and would be given in accordance with the tax treaty but that taxpayer must comply with the requirement in the Income Tax Act to be eligible for that deduction.

What could the ITAT have done differently then? Perhaps, it could have begun with an observation that the India-Mauritius tax treaty allows for full deduction of expenses and then looked at whether the IT Act stipulates any condition-precedent and, if so, what that condition is. The ITAT could then have proceeded to examine if that condition was required to be fulfilled in light of the facts of the given case and, if so, was it so fulfilled. In all likelihood, in doing so, the ITAT would have reached the same conclusion that it in fact reached. Treaties cannot be interpreted literally and courts must try to give them a liberal interpretation so that the true object and purpose of the treaty is fulfilled. In some sense, this did not happen in this case.

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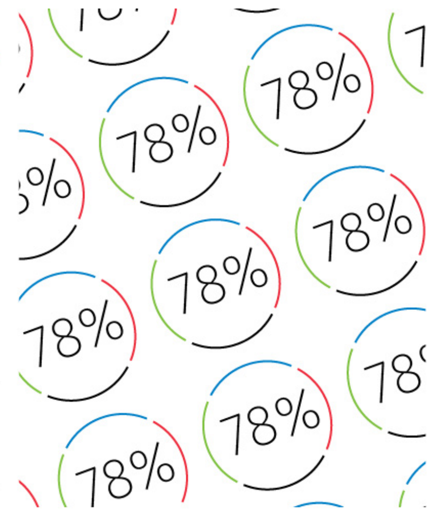

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