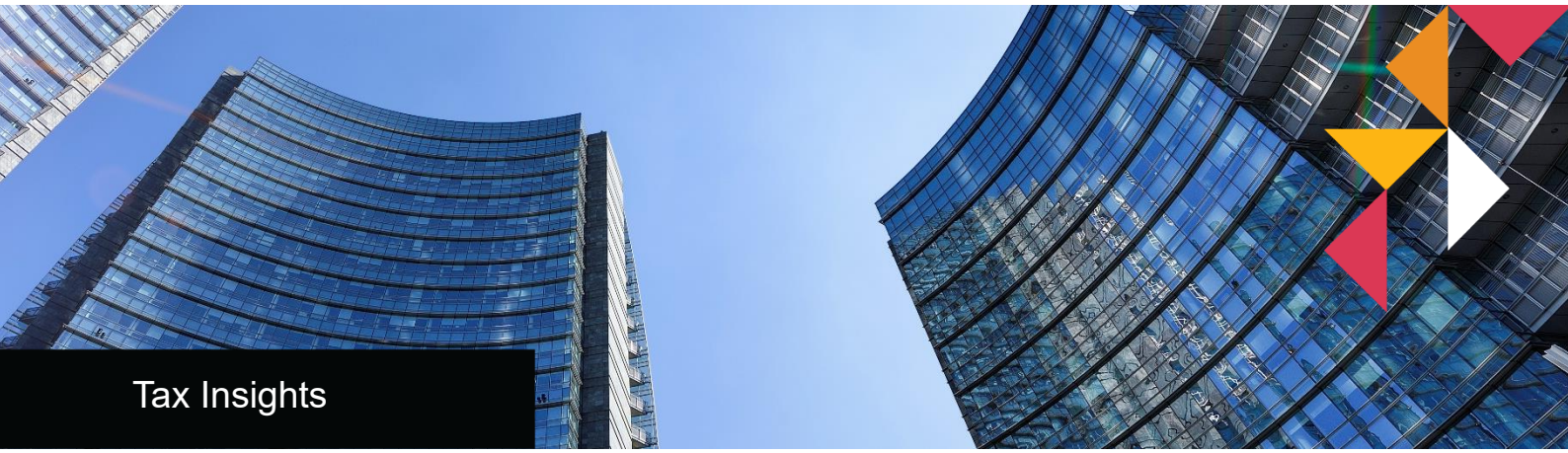

Tax Insights

11 June 2024

Interest income earned by Indian PE from overseas HO or branch not taxable in India since Indian PE is not a separate legal entity – Delhi High Court

In brief

The Delhi High Court upheld the order of the Income-tax Appellate Tribunal (Tribunal) and held[1] that the interest income earned by the Indian branch or permanent establishment (PE) of the taxpayer foreign bank from the overseas head office (HO) or other overseas branches was not taxable in India as the PE and the HO or overseas branches were not separate legal entities but one person only; additionally, one person could not earn profit from itself.

The court also noted that the explanation provided under section 9(1)(v) of the Income-tax Act, 1961 (the Act), according to which interest paid from the Indian PE of a bank to its overseas HO should be subject to tax in India in the hands of overseas HO, has no implication in the present case since the explanation came into effect from assessment year (AY) 2016-17 and the case pertains to AY 2003-04.

In detail

Facts

- The taxpayer is a multinational banking enterprise, with a PE in India comprising of branches. During AY 2003-04, the PE in India received interest income from its HO and other overseas branches. The taxpayer included this income in its total taxable income while filing its return of income but challenged it before the Commissioner of Income-tax (Appeals) (CIT(A)) on the ground that it was not taxable in India as it was a payment to self. The CIT(A) rejected the claim. However, the Tribunal allowed the taxpayer's claim following its previous order passed in the taxpayer's case.

Revenue's contentions

- Relying on the Central Board of Direct Taxes (CBDT) circular[2], Revenue argued that the PE and HO were separate entities for the purpose of taxation under the Act.
- Additionally, in absence of any specific exclusion in the India-USA Double Tax Avoidance Agreement (DTAA) on the taxability of such interest income, it cannot be excluded from computing income earned by the PE in India.

1 ITA Nos. 773 & 887/2018

2 Circular No. 15/ 2015

Taxpayer's contentions

- The taxpayer contended against considering the branch as a separate legal entity. Thus, the interest receipts of such a PE cannot be held taxable.
- The taxpayer relied on the Bombay High Court decision[3], wherein the court held that the interest received by the Indian PE from its own HO was not chargeable to tax as one cannot make a profit out of oneself.
- The taxpayer further contended that the CBDT circular[2] and explanation to section 9(1)(v) of the Act would not be applicable in the present case since it is applicable with effect from AY 2016-17, while the present case pertains to AY 2003-04.

High Court's observations and decision

- The Delhi High Court held that since the PE and HO were not separate legal entities but same person, and one person cannot earn from itself, the interest income was not taxable in India.
- Ruling in the taxpayer's favour, the court also drew support from a landmark judgement[4] of the Supreme Court. Specifically, it held that a person cannot earn profit from selling to itself; such profit, if earned, would be a fictional profit and the tax levied on such profit would also be fictional.
- The Delhi High Court also noted that the exception carved out in Article 7(3) of the India-USA DTAA for banking enterprises indicated that the interest paid by the PE to the HO or other offices was deductible in the hands of the PE. However, the present case was regarding interest income earned by Indian PE from the HO or overseas branches.
- The court also distinguished the case from the Bombay High Court decision[5], which dealt with the deductibility of interest paid by the PE to the HO under the India-Belgium DTAA, as the case had a different factual matrix and there is a specific provision allowing such deduction.
- Moreover, the Delhi High Court noted that the CBDT circular[2] and the Explanation to section 9(1)(v) of the Act, which created a statutory fiction of treating the PE as a separate and independent person, was not applicable to the case as it was introduced by the Finance Act, 2015, with effect from 1 April 2016 and the present case pertains to AY 2003-04.

The takeaways

The Delhi High Court's judgement reaffirms the principle that one cannot make a profit out of oneself. Hence, the interest received by the PE from its own HO or overseas branches is not chargeable to tax unless the Act or DTAA has a specific provision to the contrary.

However, the specific amendment in the Act with effect from 1 April 2016, which states that the interest paid by a branch of a bank in India to its HO outside India should be subject to taxes in India, may imply that the income earned by the Indian branch from its HO or overseas branches should also be subject to tax in India. Accordingly, the tax authorities and courts may not entertain the applicability of this case for the year commencing on or those after AY 2016-17.

3 DIT (I.T.) *v.* Credit Agricole Indosuez (2015 SCC Online Bom 8421)

4 Kikabhai Premchand KT *v.* Commissioner of Income-tax (Central), Bombay (1953 SCC Online SC 127)

5 DIT *v.* Antwerp Diamond Bank N. V. (Income-tax Appeal (L.) No. 2078 of 2012)

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