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Date of Publishing: February 1, 2016

# Foreign Taxes - Credit or Cost?

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*India-based taxpayers earning incomes from overseas sources tend to have such incomes taxed at different rates, subject to the local tax laws of such countries, and the applicable Double Tax Avoidance Agreement (DTAA). Such taxpayers almost invariably find themselves at loggerheads with the Indian revenue authorities over the exact amount of foreign tax credit available to them. In this article, the author has discussed, with illustration, the various modes of computation of foreign tax credit generally followed, and also attempted to highlight key controversies relating to claiming foreign tax credit in India.*

## 1. Elimination of Double Taxation

The issue of double taxation is one of the major concerns for Indian multinationals, especially those having several cross border transactions and multiple level structures, as the taxes lost can directly add up to the cost of the company. Sections 90, 90A and 91 of the Indian Income Tax Act (ITA) deal with provisions for granting relief in respect of income which is taxed in India as well as in overseas country. India has entered into (DTAA) with various countries with the objective of eliminating double taxes, exchanging information, etc.

In the context of method for elimination of double taxation, while much would depend upon a particular DTAA, in general, following methods are used for elimination of double taxation:

*i.* **Exemption Method** - Under this method, the income on which taxes have been paid in the source country is completely exempted from tax in the resident country.

*ii.* **Exemption with Progression** - Under this method, the income on which taxes have been paid in the source country is exempted from tax in the resident country, but is considered for determining the tax slab and tax rate applicable to the taxpayer.

*iii.* **Full Tax Credit Method** - Under this method, entire taxes paid in the source country are allowed as a credit in the resident country.

*iv.* **Ordinary Tax Credit Method** - Under this method, the tax credit is limited to the extent of tax attributable to doubly taxed income.

A practical illustration on elimination of double taxes under above methods has been discussed below:

Assume an Indian Company, X Ltd. earns taxable income of INR 25,000 from overseas sources. Further, assuming a tax rate of 35% in the overseas country, X Ltd. pays taxes of Rs. 8,750 in the overseas country. Further, X Ltd. earns domestic income of INR 1,00,000. Therefore, it is taxable in India on its total income of INR 1,25,000 (Indian income of INR 1,00,000 *plus* overseas income of INR 25,000) @ 30%. In this case, the credit for foreign taxes under various tax credit methods will be available as follows:

(Amount in INR)

| Particulars | Full Exemption Method | Exemption with Progression | Full Tax Credit | Ordinary Tax Credit |
|---|---|---|---|---|
| Taxable Income from India | 1,00,000 | 1,00,000 | 1,00,000 | 1,00,000 |
| Taxable Income from overseas country | 25,000 | 25,000 | 25,000 | 25,000 |
| Total Taxable Income | 1,25,000 | 1,25,000 | 1,25,000 | 1,25,000 |
| Tax paid in overseas country | 8,750 | 8,750 | 8,750 | 8,750 |
| Elimination of Double Taxation | | | | |
| Taxable income | 1,00,000 | 1,00,000 | 1,25,000 | 1,25,000 |
| Tax Liability in India before providing Foreign Tax Credit | 30,000 (30% of 1,00,000) | 35,000 | 37,500 (30% of 1,25,000) | 37,500 (30% of 1,25,000) |
| Less: Foreign Tax Credit (FTC) | *Nil* (since income itself exempt) | *Nil* | 8,750 | 7,500 |
| Net tax in India | 30,000 | 35,000 | 28,750 | 30,000 |

**Note 1:** For the limited purpose of discussing the concept of exemption with progression, it is assumed that income up to INR 1,00,000 is subject to 30% tax and income above INR 1,00,000 is subject to 35% tax. Accordingly, the foreign income is considered only for the determination of tax rate in India.

It is pertinent to note that Indian DTAAs generally provide for ordinary tax credit method for providing relief in double taxation scenarios. Thus, whenever any income suffers double taxation, relief is provided to the taxpayer by allowing him relevant foreign tax credit, subject to the tax actually suffered by the taxpayer on such income in India.

**2. The Controversy - Requirement of Taxes Actually Paid?**

An important question that arises for consideration is whether the taxpayer needs to be actually subject to double taxes *i.e.* taxes need to be actually doubly paid in order to be able to claim foreign tax credit, or a mere liability to pay tax is sufficient to claim foreign tax credit?

It is relevant to note here that certain DTAAs include tax sparing provisions. Tax sparing provision provide for tax credit on deemed basis at the tax rate applicable in the source country, although the income is actually exempt from taxation in the source country owing to certain incentives provided by the source country.

However, the above provisions are generally in the context of allowability of tax paid in the source country. **A question still remains as to the allowability of foreign tax credit when there is no tax actually paid/payable in the country of residence**?

Guidance in this regard can be obtained from couple of judicial precedents available in the context.

i. ***Infosys Technologies Ltd.* v. *Jt. CIT*[1]**

In this case, based on a perusal of Article 23 of India-Canada DTAA, the Bangalore Tribunal held that foreign tax credit was available only if the income had been subjected to tax, both in India and Canada. Further, it is a well settled law that relief under DTAA is available only when same income has suffered tax in both countries. The gross amount subjected to tax in Canada was not the income on which ultimately tax was charged in India. The income on which tax was levied in India was either in respect of partial income of eligible units claiming deduction under section 80HHE or other income. If it could be found that the entire receipts charged in Canada were exempt under the provisions of Indian tax laws, the taxpayer was only paying tax on income otherwise chargeable in India and not on income which was doubly taxed. Thus, in such a situation, the taxpayer was not permitted to claim credit of tax paid against income, which is otherwise legitimately chargeable to tax in India. Accordingly, credit for the Canadian tax was allowed only on that portion of the income that was taxed in Canada as well as in India.

ii. ***Manpreet Singh Gambhir* v. *Dy. CIT*[2]**

In this case, the Delhi Tribunal held that in case the taxpayer is not liable to pay tax or if the tax payable by him because of deduction/exemption granted is less than the tax payable outside India, the taxpayer cannot claim credit for entire taxes paid, and that tax credit could be allowed only against doubly taxed income. In rendering this decision, the Tribunal relied on the decision of ***The Hon'ble Rajasthan High Court in the case of CIT v. R.N. Jhanji*[3]** and that of ***The Hon'ble Andhra Pradesh High Court in the case of CIT v. M.A. Mois*[4]** wherein it was held that *"where the assessee is entitled to special deduction under section 80RRA to the extent of 50% of the remuneration received, he would be entitled to relief under section 91(1) of the amount of tax paid on 50% of the foreign income".*

The Delhi Tribunal held that though the above referred decisions were rendered in the context of section 91 of the ITA, the spirit of ratio laid down is applicable for claiming credit even under section 90 - there should be real double taxation of same income in both countries. There cannot be a situation of payment of taxes outside India and claiming refund in India without actually incurring liability for paying taxes in India.

**iii. *Durametallic (India) Ltd.* v. *Asstt. CIT*[5]**

The issue in the concerned case was as to what was the amount of Singapore tax payable by the taxpayer in respect of which it had been subjected to tax in both countries. The Tribunal held that the expression 'subjected to tax' has a narrower meaning, and it refers to the amount of income on which tax has been levied. In the instant case, though 'income chargeable to tax' in both countries was royalty under the Indian-tax laws, the taxpayer was allowed deduction under section 80-O and tax was levied in India on the net amount only. Hence, only 50% of the royalty on which tax was levied in India, could be considered as income subjected to tax in India. The intention behind the DTAA is to remove the hardship caused to a taxpayer by the burden of double taxation on the same quantum of income. The Tribunal further relied on the decision of **The Hon'ble A. P. High Court** in the case of ***CIT v. C.S. Murthy*[6]**, wherein it was held that *"as the assessee has been granted deduction under section 80RRA on 50% of the remuneration from foreign employer, only balance amount shall be subjected to tax in India and so relief on double taxation shall be available only on 50% of the remuneration*."

**iv. *Arvind Metals & Minerals (P.) Ltd.* v. *Dy.CIT* [7]**

In the concerned case, the taxpayer claimed credit for entire taxes paid in Thailand. However, the Indian tax authorities restricted the tax credit only to the extent of 69% (on proportionate basis). The Kolkatta Tribunal upheld the view of the Indian tax authorities and held that the amount of foreign tax credit allowable in India was not to exceed the taxpayer company's tax liability in India.

There are also other decisions incorporating similar views. Based on the prevalent judicial view of tax authorities if the income has been **actually subject to tax in India and in overseas country**, then foreign tax credit will be allowed to the taxpayer. However, it is worth mentioning here the recent decision of Mumbai Tribunal in the case of **Blue Star Infotech Ltd.**

**v. *Blue Star Infotech Ltd.* v. *Asstt. CIT* [8]**

In the concerned case, the taxpayer had claimed credit for taxes paid in foreign country. However, the lower tax authorities did not allow the claim of taxpayer. Further, the tax authorities contended that under Article 23(2) of India-Japan DTAA, deduction shall not exceed that part of the income tax which is attributable to income which is taxed in Japan. The Indian tax authorities held that the entire income of taxpayer carries the benefit of section 10A, and as such, no tax had been paid by the taxpayer in India on its income which was attributable to Japan, hence, the credit for Japanese taxes could not be allowed.

The taxpayer on the other hand contended that income of taxpayer was not exempt under section 10A of ITA, instead, a deduction of such profit and gains was allowed from its total income. The taxpayer further contended that merely because it has availed of a deduction did not mean that corresponding income had not been charged to tax.

The taxpayer further contended that the DTAA should be given a liberal interpretation. Further, relying on tax sparing clause provided under the DTAA, the taxpayer contended that tax credit should be allowed to it. Additionally, the taxpayer also relied on the Article 24 of the DTAA dealing with Non-Discrimination and contended that on one hand the taxpayer was being discriminated against a resident of Japan to whom the incentive of section 10A was expressly passed over in the double taxation relief granted to him against his tax liability in Japan (by virtue of the tax sparing clause); and on the other hand it was being discriminated against an Indian resident who does not earn export income and does business in domestic market only. Thus the taxpayer argued that the treatment sought to be given by the Revenue in the instant case yielded absurd result.

The Mumbai Tribunal held that the deduction under section 10A of ITA being from the total income leads to the conclusion that there is charge of income tax in India also on the income that has been subjected to tax in Japan. It held that the tax liability of the taxpayer was equal to the tax payable in India at normal rates. Accordingly the taxpayer qualified for tax relief under para 2a of Article 23 of India-Japan DTAA.

The Tribunal further held that Article 24 of the DTAA envisages parity of tax liability between the residents of India and Japan. By virtue of paragraph of Article 23 of DTAA, the resident of Japan obtains tax relief as if Indian tax has not been reduced by the provisions of section 10A. On the same logic, it held that tax relief to a resident of India should be calculated as if the Indian tax has not been reduced in his case by the provisions of section 10A. Thus, the Tribunal allowed credit for foreign taxes against the tax levied on the corresponding income eligible for deduction under section 10B of the Act in India.

While the decision permits foreign tax credit even in case the income under consideration is eligible for tax relief, there are certain aspects in the decision relating to tax sparing, non-discrimination that may need consideration by taxpayers relying on this ruling for their matters. Also, the concerned case has not considered the earlier judicial precedents available on the subject.

**3. Other Key Issues**

i. **Set off income or loss from various sources in the same country**

The Bombay High Court's decision in the case of ***CIT v. Bombay Burmah Trading Corpn. Ltd.*** [9] provides that the relief for foreign tax credit has to be worked out country-wise.

However, question is what happens if there are two sources of income from the same source country (say, one resulting into a loss and other into a profit)? Guidance in this matter can be obtained from the old decision of Supreme Court in the case of ***Carew & Co. Ltd.*** [10], wherein it was held that each category/source of income has to be considered separately and the taxpayer was held to be entitled to foreign tax credit without setting off loss from one source of income with another.

ii. **Credit for additional taxes deducted in the source country**

It may be quite possible that in certain cases, sometimes taxes may have been withheld at higher rate in the source country, (say for instance, 25% instead of 15% withholding tax rate provided under DTAA). Question arises whether in such a situation, foreign tax credit can be claimed for entire tax of 25%. Here, it is pertinent to note that DTAAs generally provide for credit for only those taxes as are deducted in accordance with the provisions of DTAA. Accordingly, in the given illustration, it may be possible to get credit for only 15% and not 25%. A linked question is whether in such a situation, can one invoke the provisions of unilateral tax credit mechanism provided for in section 91, since such excess withholding tax (10% in the given illustration) is not covered under DTAA? It appears that even under the unilateral credit mechanism, this may not be possible, since the provisions of unilateral tax credit are invoked if there is no DTAA applicable in respect of the income under consideration. Accordingly, in the given case, it may not be possible to claim the excess taxes deducted even under unilateral tax credit provisions.

### iii. Different classification of income in source country and resident country

It is possible that a particular payment may be categorised differently under the domestic tax rules of the resident country and source country. For instance, a particular lease arrangement may be classified as operating lease under the source country laws and the entire amount may be subject to withholding tax. However, the same lease arrangement may be considered as financial lease under the resident country's laws thereby implying only the interest component of lease payment will be taxable in the resident country. Consequently, in such situations, due to different classification of same income in source and resident country, the entire tax credit may not be available.

## 4. Powers to Central Board of Direct Taxes (CBDT) to Make Rules

*Vide* Finance Act, 2015, powers have been given to the CBDT to make rules to provide procedure for granting relief/deduction of foreign tax credit.

## 5. Conclusion

Considering the controversy surrounding foreign tax credit rules, approach of the revenue authorities, and different tax regimes prevalent in India and various foreign countries, availing foreign tax credit could be fraught with controversy and litigation with Indian revenue authorities. In fact, the situation is aggravated since the Indian tax laws currently do not permit carry forward of foreign tax credit in years where no taxes are actually payable (say, due to tax losses) to be set off against future years, resulting in potential double taxation. To illustrate, assume an Indian company, Y Ltd., is receiving dividends from a subsidiary established in an overseas country - country A. The dividends are subject to withholding tax in country A. However, Y Ltd. is incurring losses, and it is therefore not able to claim foreign tax credit since it does not have any taxable income in India, and consequently no taxes actually paid in India, against which the foreign taxes can be offset. In such cases, dividends will suffer withholding tax in the country A, and Y Ltd. will be taxable in India in the year of earning taxable profits in subsequent years. In such years, Y Ltd. will not be able to claim foreign tax credit (taxes withheld on dividends) to offset the tax liability in future years. These kinds of situations could potentially increase the tax cost for Indian taxpayers earning taxable incomes from overseas.

It is hoped that the CBDT will consider the above issues, and the yet-to-be-announced Rules provide much needed clarity on this extremely crucial area of dispute.

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- The views expressed in this Article are author's personal views.

1. [2007] 108 TTJ 282 (Bang.).

2. [2008] 26 SOT 208 (Delhi).

3. [1990] 185 ITR 586/[1988] 40 Taxman 428 (Raj.).

4. [1994] 210 ITR 284 (AP).

5. [2003] 85 ITD 442 (Mad.).

6. [1988] 169 ITR 686/37 Taxman 185 (AP).

7. IT Appeal No. 777 (Kol.) of 2010.

8. [2015] 57 taxmann.com 386/154 ITD 81 (Mum. - Trib.).

9. [2003] 259 ITR 423/126 Taxman 403 (Bom.).

10. [1979] 2 Taxman 300/120 ITR 540 (SC).