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Deciphering the "Non Discrimination" Clause

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Introduction

1. Every cross-border business transaction involves two potential tax claims, *viz.,* one in the country to which the person belongs to (*i.e.,* the country of domicile/residence) and the other, the country in which the investment is made or where the business is transacted (*i.e.,* country of source of income). Both countries may exercise jurisdiction for taxing a particular income. This results in Double Taxation of the same income. Such double taxation of income is a great disincentive, as it hampers free flow of capital and becomes a burden on taxpayers leading to decline in foreign investments.

To avoid such double taxation and to facilitate international trade and investments, countries enter into Double Taxation Avoidance Agreement (DTAA/Treaty). DTAAs provide a degree of certainty to businesses by clarifying taxing rights of each State, avoiding double international juridical taxation and preventing fiscal evasion through anti-avoidance provisions. However, there may arise cases where a country provides favourable treatment to its nationals and discriminates against foreigners. To circumvent such cases DTAAs provide a clause which restricts Contracting States from offering discriminatory treatment to foreign nationals as compared to its nationals.

2. OECD Model Tax Convention

- Discrimination means unequal treatment in situations which are identical or similar. As a corollary, non-discrimination means two persons who are similarly situated must be treated similarly. Article 24 of the OECD Model Tax Convention deals with non-discrimination provisions; nationality non-discrimination, permanent establishment non-discrimination, and deduction and ownership non-discrimination. The clause primarily aims at ensuring to nationals of another Contracting State, residents of any third State and Stateless persons equality of treatment with the nationals of the Contracting State with regard to taxation and laws connected therewith.
- Article 24 of the OECD Model Convention[1], which provides for protection against non-discrimination, reads

as follows:

1. *Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances, in particular with respect to residence, are or may be subjected. This provision shall, notwithstanding the provisions of Article 1, also apply to persons who are not residents of one or both of the Contracting States.*
2. *Stateless persons who are residents of a Contracting State shall not be subjected, in either Contracting State, to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of the State concerned in the same circumstances, in particular with respect to residence, are or may be subjected.*
3. *The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.*
4. *Except where the provisions of paragraph 1 of Article 9, paragraph 6 of Article 11, or paragraph 4 of Article 12, apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, or the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State. Similarly, any debts of an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable capital of such enterprise, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State.*
5. *Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of*

the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first mentioned State are or may be subjected.

6. *The provisions of this Article shall, notwithstanding the provisions of Article 2, apply to taxes of every kind and description.*

- The basic premise of Article 24 is that residents of a Contracting State cannot be subjected by other Contracting State to any taxation and compliance requirements which are more burdensome than those which residents of other Contracting State in similar circumstances are subjected to. The four pillars of non-discrimination essentially are as follows:
    1. To prevent discrimination of resident of a Contracting State by another Contracting State with respect to any taxation or compliance burden, which is more burdensome to which residents of that other State in "similar circumstances" are subject to.
    2. Prevention of discrimination to Stateless persons in the same manner as 1 above
    3. Non-discrimination of residents of other State in two cases, both relating to business income, (a) permanent establishment, deduction in computing business profits of interest, royalties and other disbursements
    4. Non-discrimination of Enterprises owned by treaty partner residents (similar to paragraph 1 above)
- Hence, the provision is a specific enunciation of the general principle of equality. Essentially, the principle stipulates that similar transaction shall not be treated differently, unless differentiation is objectively justified. Different treatment constitutes no discrimination when it is objectively justified or atleast in economic matters is not arbitrary.

Judiciary Adjudication

3. The Indian judiciary has adjudicated on a few cases in the recent years, which are briefly discussed as follows:

3.1 *CIT* v. *Herbalife International India (P.) Ltd.*[2]: The Delhi High court in this decision held that the provisions of section 40*(a)(i)* of the Income-tax Act, 1961 ("Act"), before insertion of sub-clause *(ia)* in section 40*(a)* by the Finance (No.2) Act, 2004, were

discriminatory in nature, as it provided for disallowance of payments made to non-residents where tax was not deducted at source, whereas similar payments to residents did not result in any such disallowance.

The taxpayer, an Indian subsidiary, entered into an Administrative Services Agreement ("Agreement") with Herbalife of International America Inc. (US Co.) for the provision of certain administrative services. The Assessing Officer ("AO") disallowed the administrative fee paid in the hands of the taxpayer on account of non-deduction of tax at Source on the ground that the same were in the nature of Fee for Technical Services ("FTS") under the Act as well as under the DTAA.

The Delhi High Court held that the expenditure was disallowed under section 40*(a)(i)* of the Act, for the year under consideration, if payment was made to a non-resident. The disallowance of expenses for non-deduction of tax on payments made to a resident was inserted by way of section 40*(a)(ia)*, only with effect from April 1, 2005. Before such insertion, the condition under which expenses were deductible, i.e., whether tax was deducted or not was not the same in respect of payments to residents and non-residents. While as tax deduction from payments to non-residents may be justified, that does not meet the test of Article 26(3) as regards condition for deductibility of the payment itself. The conditions for deductibility were plainly different in respect of payments made to residents and non-residents. Therefore, non-discrimination rule under Article 26(3) of the DTAA was attracted. The plea of the Revenue that unless there are provisions similar to section 40*(a)(i)* of the Act in the DTAA, a comparison cannot be made to determine which is a more beneficial provision is erroneous. The provisions of the DTAA will prevail, unless any specific provision in the Act is more beneficial to the assessee.

The High Court in the instant case while referring to OECD discussion draft on interpretation of Non-discrimination Article in tax treaties indicated, that though the scope was restricted and seemingly justified withholding taxes on payments to non-residents, yet what mattered was not the requirement to withhold taxes but the consequence of not withholding.

3.2 *Mitsubishi Corporation India (P.) Ltd* v. *Dy. CIT*[3]: Recently, the Delhi Bench of the Income-tax Appellate Tribunal (ITAT) held that no disallowance under section 40*(a)(i)* of the Act shall be made if payments are taken into account by the non-resident recipient in its computation of income, taxes on such income are paid and income-

tax return has been filed by such recipient, in view of non-discrimination clause in the India-Japan tax treaty (DTAA). Further, the Tribunal observed that different tax treatment to the foreign enterprise *per se* is enough to invoke the non-discrimination clause in the tax treaty.

The Taxpayer, an Indian subsidiary of Mitsubishi Corporation Japan (Japan Co.), made payments to Japanese Co. for purchase of goods. Japanese Co. had Siaison offices in India. Even after the incorporation of the taxpayer in India, Japanese Co. continued to operate through LO and looked after its interests. The Assessing Officer (AO) held that since Japanese Co. had a Permanent Establishment (PE) in India, the taxpayer was required to deduct tax from the payments made to Japanese Co. Since the taxpayer had failed to deduct tax at source under section 195 of the Act, the payments were disallowed under section 40*(a)(i)* of the Act.

The ITAT opined that the discrimination was glaring inasmuch as when payments were made to a resident assessee, which essentially had an income embedded in it, there was no tax deduction at source requirement, whereas when payment was made to a non-resident Japanese assessee, whether or not there was any income embedded in it, tax was required to be deducted at source. If this kind of a discrimination was permitted, non-discrimination clauses in the tax treaties would be rendered meaningless. The assessee then moved on to legislative amendments to section 40*(a)(ia)* by virtue of the Finance Act 2012, and by inserting second proviso to section 40*(a)(ia)*. It is pointed out that in view of this amendment, when an assessee makes a payment, even without deducting tax at source, to the resident assessee but resident assessee takes into account such receipt in its computation of income and files the income-tax return under section 139(1) in respect of income so computed, no disallowance under section 40*(a)(ia)* can be made. However, in corresponding provision for payments made to non-resident assessees, *i.e.,* under section 40*(a)(i)*, when an assessee makes payments to non-resident assessees without deducting tax at source and even if the recipient takes into account such receipts in his computation of business income and files return under section 139(1) in respect of the same, the disallowance will be made nevertheless. The assessee submitted that since the provision of section 40*(a)(ia)* was held to be retrospective with effect from 1-4-2005 by a co-ordinate bench's decision in the case of *Rajeev Kumar Agarwal* v. *Addl. CIT*[4]*,* there was a clear discrimination, so far as deductibility of the related amounts paid to Japanese Co., a Japanese tax resident, was concerned.

3.3 In the case of *Bank of America* v. *Dy. CIT*[5], the Mumbai ITAT held that if as per the agreement between the two countries there was a restriction in the rate of tax chargeable in the case of foreign companies, the effect would have to be given to the provisions of the agreement in preference to the provisions of the Act.

3.4 In the case of *Rolls Royce Industrial Power Ltd*. v. *Asstt. CIT*[6], the Delhi ITAT commented on the scope of Article 26(2) of the India-UK DTAA (which deals with the PE of a non-resident not being treated less favourably than a resident). As per the Delhi ITAT, to attract the non-discrimination clause, it must be shown: firstly, the non-resident company is taxed in a manner that is more burdensome *vis-à-vis* an Indian company, and secondly, the resident company being compared to must be in an identical business as the non-resident company.

Conclusion

4. While the law on interpretation of tax treaties is evolving with times and it is a recognised fact that the Indian Courts have been making a fair contribution to this progress, it would be interesting to see whether the Courts continue to attribute a broad meaning to non-discrimination clause or a more contextual meaning needs to be drawn while interpreting the non-discrimination clause so as to ensure that the results fall within the overall backdrop of the negotiations of the particular treaty. As the Indian economy witnesses increased cross border transactions, there will be more and more litigations of alleged discrimination cases in more Court rulings on the subject, possibly on different parameters and premise, relevant to specific treaty. Double taxation is an evolving field. The resolution of each dispute shall add further clarity to the subject.

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