DISALLOWANCE FOR FAILURE TO WITHHOLD ON OUTBOUND PAYMENT VIOLATES INDIA-U.S. NON-DISCRIMINATION CLAUSE

Authors
Neha Rastogi
Nina Krauthamer

Tags
India
Non-discrimination Clause
Tax Treaties

Herbalife International Private Limited (the "Taxpayer") was an Indian subsidiary of Herbalife International Inc., a U.S. corporation, engaged in the business of trading and marketing of herbal products used for weight management. During the tax year 2000-2001, the Taxpayer paid an administrative fee to Herbal International of America Inc. ("HIAI"), an affiliate U.S. corporation, in consideration for administrative services rendered by the latter.

The Taxpayer claimed this payment as deduction when computing its taxable income. The Taxpayer did not withhold tax at the time payment was made to HIAI, a nonresident, which was, nonetheless, required under the Indian Income-tax Act, 1961 (the "I.T. Act"). However, no such withholding requirement existed under the I.T. Act with respect to payments made to residents, for the year in question. The requirement of withholding tax on payments made to residents was inserted, for the first time by way of Section 40(a)(ia) of the I.T. Act, *vide* Finance Act, 2004.

The Hon'ble Court of Delhi (the "H.C.") considered the allowance of the administrative fee under Section 40(a)(i) of the I.T. Act, in light of the non-discrimination clause under Article 26 of the India-U.S. Tax Treaty (the "Treaty").

The H.C. explained that Section 40 of the I.T. Act, which requires withholding, overrides other provisions under the I.T. Act that provide for deductibility of expenditure.[1] Generally speaking, the payment of an administrative fee to HIAI would be allowable under Section 37(1) of the I.T. Act, but before this payment can be allowed, the condition regarding withholding of tax when the recipient is a nonresident must be satisfied.[2] In other words, if taxes are not withheld from the payment being made to a nonresident, then Section 40(a)(i) of the I.T. Act provides for disallowance of the expenditure for purposes of computing the taxable income of the payer.

The H.C. considered the provisions of the non-discrimination clause[3] in the Treaty to ascertain whether withholding on the payment made to HIAI (*i.e.*, payment made to a nonresident) is any different from the allowance of such payment as a deduction when it is made to a resident.

The H.C. noted that Section 40(a)(i) of the I.T. Act, as it stood during the relevant tax year,[4] did not provide for the withholding requirement where the payment was made in India to a resident. However, as far as payment to a nonresident is concerned,

---

1 Sections 30 to 38 of the I.T. Act.

2 Section 40(a)(i) of the I.T. Act.

3 Article 26(3) of the India-U.S. Tax Treaty.

4 *I.e.*, before insertion of sub-clause (ia) in Section 40(a) by the Finance Act, 2004.

Section 40(a)(i) of the I.T. Act, as it stood at the relevant time, mandated that if tax is not withheld at the time of payment, it will not be allowed as a deduction when computing the taxable profits of the payer.

Therefore, the H.C. observed that the lack of parity in the allowance of the payment as deduction results in discrimination against nonresidents under Article 26(3) of the Treaty. The H.C. thus held that the provisions of Section 40(a)(i) of the I.T. Act were discriminatory, being more onerous for nonresidents and, therefore, not applicable. As a result, the H.C. allowed the deduction of the expenditure for computing taxable income of the Taxpayer, despite the failure to withhold tax.

It may be noted that the rationale of the H.C. is not applicable to payments made after April 1, 2004, since the Finance Act, 2004 amended Section 40 of the I.T. Act to introduce withholding tax requirements where the recipient is a resident in India, thereby eliminating any discriminatory treatment and introducing parity in disallowance among residents and nonresidents in India.