A Delhi Bench of the Indian Income Tax Appellate Tribunal (the Tribunal) recently denied deduction for an Indian PE’s interest expense to its UK bank’s head office (HO).

The taxpayer, Standard Chartered Grindlays Pty Ltd, is a banking company incorporated in the United Kingdom and it operates in India through its network of branches. In 1992, a dispute arose between the taxpayer and National Housing Bank (NHB), a wholly owned subsidiary of India’s Apex Bank i.e Reserve Bank of India (RBI). Pursuant to the same, the RBI issued a directive under section 35A of the Indian Banking Regulation Act, directing the taxpayer to deposit the disputed amount with NHB. In connection with this deposit, the taxpayer’s Indian branch (i.e India PE) borrowed funds from its head office (HO) in the United Kingdom and paid an interest of Rs. 24.8 crore on this to its HO during the relevant tax year 1995-96. This interest payment was claimed as deduction in computation of business income, in accordance with article 7(7) of the Indo-UK Double Taxation Avoidance Agreement (DTAA), and the same was denied by tax authorities in India. Aggrieved, the taxpayer filed an appeal before the Tribunal.

Article 7(7) of the DTAA provides that payments in the nature of royalties, fees, commission, interest on monies lent etc. made by a PE to a head office or other offices of the enterprise shall not be taken into account in the determination of profits of PEs. However, an exception is provided in case of banking enterprises where an amount paid by a PE to an HO by way of an interest on monies borrowed is an allowable expenditure. Thus, the Indo-UK DTAA specifically permits tax deductibility of interest paid by the PE of a banking company to its HO for monies borrowed for the business of the PE. However, as per article 7(5) of the Indo-UK DTAA, for the purpose of determination of profits attributable to PE, if any expenditure is not allowable under domestic law, it will not be allowable even under the DTAA.

Ruling against the taxpayer, the Tribunal upheld denial of deduction for Rs. 24.8 crore interest paid by the Indian branch (i.e. the permanent establishment (PE)) on the foreign currency loan availed from its head office for making deposits in India. Referring to article 7(5) and 7(7) of the DTAA, the Tribunal noted that the expense deductions to the PE shall be subject to domestic law limitations. The Tribunal held that, under the Indian Income-tax Act, interest paid by a branch to its head office is not deductible. As payment of interest by a PE to an HO amounts to payment to itself, it is not tax deductible under domestic tax law, noted the Tribunal.

The Tribunal rejected the taxpayer’s reliance on the Mumbai Tribunal Special Bench ruling in Sumitomo Banking Corporation, which was delivered in the context of the India-Japan treaty. The Tribunal accepted the Revenue’s argument that the India-Japan treaty is distinct from the Indo-UK treaty and, as per article 7(3) of the India-Japan DTAA, there is no stipulation that interest deduction is subject to domestic law.