FOREIGN TAX CREDITS MADE EASY

Recently, in the case of Wipro Limited (the "**Taxpayer**"), the Karnataka High Court (the "**KHC**") has held that a foreign tax credit can be claimed against Indian income under the provisions of section 90(1)(a)(i) of the Income-tax Act, 1961 (the "**Act**"), irrespective of the fact that the income is eligible for a deduction under section 10A of the Act.

Facts

The Taxpayer is a company listed in India and the United States of America (the "**USA**"). The Taxpayer is, *inter alia*, engaged in the business of software exports, and supply of computer peripherals and IT-enabled services, and carries on its business through the various business units which are independent profit centers. Books of accounts are maintained unit wise, and the accounts are eventually consolidated. The Taxpayer has a permanent establishment ("**PE**") in countries such as the USA, the UK, Canada, Japan and Germany. The Taxpayer computes the profits attributable to the PEs, pays the applicable income tax on such profits and files returns of income as required by the domestic tax laws of the respective countries. The clients in some countries withhold tax at source from the consideration payable to the Taxpayer, which is regarded as the final tax payable in those countries.

The Taxpayer, being an Indian company as per section 2(26) of the Act and also a tax resident in India in terms of section 6 of the Act, is liable to tax in India on its worldwide income, including the profits attributable to its PEs and incomes which are subject to withholding tax in foreign countries.

This judgment of the KHC arises out of appeals filed by the Taxpayer and the Indian tax authorities (the "**ITA**") in relation to the income tax payable by the Taxpayer for the assessment years 2001-02, 2002-03, 2003-04 and 2004-05.

Section 10A of the Act, *inter alia*, exempts income earned from export of software and allows a registered software unit a tax deduction for a period of ten (10) consecutive years. Separately, section 90(2) of the Act allows a taxpayer to avail either the provisions of the Act or the DTAA, whichever are more beneficial to the taxpayer, and section 90(1)(a)(i) of the Act provides that if the taxpayer is subject to income tax in a foreign country as well as in India, the tax paid in the foreign country will be eligible for a tax credit in India.

The Taxpayer claimed a tax credit in respect of the tax it had paid under various foreign state and federal laws, through the applicable DTAAs. The ITA denied the Taxpayer's claim with respect to the foreign tax credits and, therefore, the Taxpayer filed an appeal before the Commissioner of Income-tax, (Appeals) (the "**CIT**(**A**)"). The CIT (A) held that the Taxpayer should be eligible for the foreign tax credits claimed. Aggrieved by the CIT (A)'s decision, the ITA preferred an appeal before the Income-tax Appellate Tribunal (the "**ITAT**"). The ITAT agreed with the ITA and held that the Taxpayer should not be eligible for foreign tax credits. The Taxpayer appealed to the KHC.

KHC's ruling

The KHC has held that:

- Chapter III (which includes section 10A) of the Act deals with income forming part of the total income on which no income tax is payable; however, such exempted income is to be included in the total income of the Taxpayer. The relief under section 10A of the Act is in the nature of an exemption although it has been termed as a deduction;

- the power to grant an exemption from payment of tax under the Act includes *the* power to modify or withdraw the same; the exemption by its very nature is susceptible of being revoked or modified or subjected to further conditions;

- the tax credit for the income tax paid in a foreign territory is *available* under section 90(1)(a) of the Act, even if the income is not taxable under section 10A of the Act (relying on the decisions of India's Supreme Court in the cases of: (i) *Wallace Flour Mills Contracting State Ltd Collector of Central Excise, Bombay Division III*, (1990) 186 ITR 440 (SC), and (ii) *Kanishka Trading and another v. UOI*, AIR 1995 SC 874, wherein it was held that merely because the exemption was granted in respect of the taxability of a particular source of income, it could not be said that the entity was not liable to tax at all);

- *Article* 25(2)(a) of India's DTAA with the USA (the "**US DTAA**") provides that the income of an Indian resident subject to tax in the USA will be allowed as a deduction in India from income tax, whether directly or by deduction;

- Article 25(2)(a) of the US DTAA does not *impose* a condition that income tax must be paid by the Indian resident in India for claiming the foreign tax credit as a deduction;

- Article 23 of India's DTAA with Canada (the "**Canada DTAA**") provides that income subject to tax in Canada is to be allowed as a deduction against Indian tax payable in respect of such income, although if any income is not liable to be taxed in India, the Indian resident will not get a benefit under the Canada DTAA and such income will taxed in Canada.

After assessing the US DTAA and the Canada DTAA, the KHC ruled that if an Indian resident has paid income tax in a foreign jurisdiction, then he will be eligible for a deduction with respect to that amount from the income tax payable by him in India.

The ITA argued that the amendment to section 90(1) of the Act to include the relief under section 90(1)(a) of the Act was brought into force only in 2004, whereas the assessment years in question were prior to the amendment. Therefore, the section could not be said have retrospective effect. However, the KHC placed reliance on the *Azadi Bachao* case *(Appeals (civil) 8161, 8162, 8163 and 8164 of 2003 (SC))*, and held that the amendment was only clarificatory in nature and because the provisions of the DTAA were more beneficial to the taxpayer, they would be applicable to the taxpayer.

The KHC also relied on Circular No.333 dated April 2, 1982 and held that the correct legal position is that where a specific provision is made in the DTAA, that provision will prevail over the general provisions contained in the Act. DTAAs which have been entered into by the Central Government under section 90 of the Act also provide that the laws in force in either country will continue to govern the assessment and taxation of income in the respective country except where provisions to the contrary have been made in the DTAA. Thus, where a DTAA provides for a particular mode of computation of income, this should be followed, irrespective of the provisions in the Act. It is only where there is no specific provision in the DTAA, that the basic law, i.e., the Act, will govern the taxation of income.

Majmudar's comments

The KHC judgment clarifies the position and provides an insight into how a foreign tax credit can be claimed under the DTAA and the Act. The judgment explains that merely due to the fact that a deduction or income exemption has been provided in the Act, a foreign tax credit cannot be denied. The judgment reiterates that the provisions of the DTAA will supersede the provisions of the Act, to the extent that they are more beneficial to the taxpayer. The judgment has also paved the way for an amendment of section 295 of the Act, to allow the Central Board of Direct Taxes to make rules for the purpose of granting relief for deduction of foreign taxes paid in foreign countries. Nevertheless, the KHC's decision is appealable to the Supreme Court. We hope that no further appeal is preferred by the ITA, and that the Modi government continues to implement its stance of having a friendly tax regime.