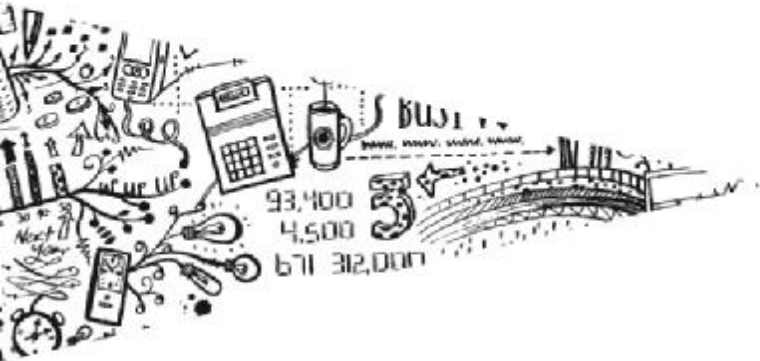


1 June 2011

EY Tax Alert

Delhi HC rules discounting charges made for bills of exchange are not interest



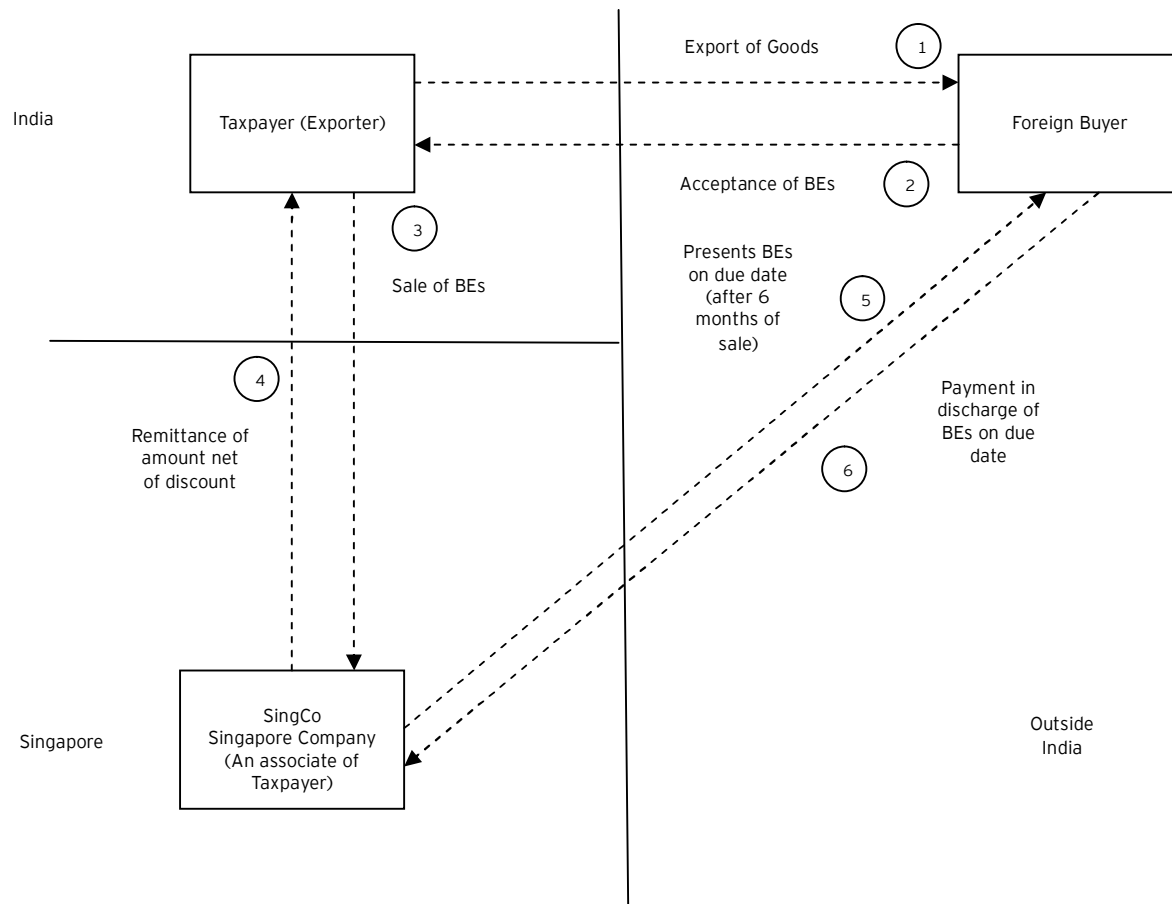
Executive summary

This Tax Alert summarizes a recent ruling of the Delhi High Court (HC) [2011-TII-20-HC-DEL-INTL] in the case of Cargill Global Trading Pvt. Ltd (Taxpayer) on the issue of whether discounting charges paid to a non-resident on discounting of bills of exchange (BEs) can be characterized as 'interest', liable for withholding. The HC held that the discounting charges are not in the nature of 'interest' since they are not payable in respect of money borrowed or debt incurred by the Taxpayer. Accordingly, the discounting charges are business income, not covered by the special source rule applicable to interest income. As the recipient non-resident does not have a permanent establishment (PE) in India, it is not liable to tax in respect of such discounting charges and, consequently, the Taxpayer is not obliged to withhold tax from such payment.

Background and facts

- ▶ The Taxpayer is in the export business. On exports made by the Taxpayer on credit terms, the Taxpayer draws BEs on the buyers for the sale value, with a maturity period of about six months. The Taxpayer discounts the BEs with its non-resident associate concern, a company that is a tax resident of Singapore (SingCo), on 'without recourse' basis. SingCo is engaged in the business of underwriting, acquiring, owning, selling etc., of securities, negotiable instruments, commercial papers etc., and has no presence in India.

- ▶ The flow of transactions between the Taxpayer, its export customer and SingCo is pictorially depicted below:



- ▶ On account of discounting on 'without recourse', SingCo purchases BEs on its own behalf and collects payment for itself on the due date and has no right to proceed against the Taxpayer even if there is default by the foreign buyer.
- ▶ The difference between par value of BEs and the amount at which BEs are sold to SingCo represents discounting charges. Such discounting charges were claimed as tax deductible expenditure by the Taxpayer.
- ▶ The term 'interest' is defined in the Indian Tax Laws (ITL), in a broad manner, to include interest payable in any manner in respect of any moneys borrowed or debt incurred. Under the ITL, 'interest' also includes any service fee or other charge in respect of moneys borrowed or debt incurred or in respect of any credit facility which has not been utilized.
- ▶ The characterization of payment as 'interest' attracts withholding obligation for the Taxpayer in terms of the provision of the ITL as also the provisions of the India-Singapore Double Taxation Avoidance Agreement (DTAA). Failure to withhold tax attracts disallowance in computation of business income.
- ▶ The Taxpayer did not withhold tax on discounting charges on the basis that it did not represent 'interest', either under the ITL or under the DTAA.
- ▶ However, the Tax Authority held that the discounting charges were in the nature of 'interest' and disallowed the claim by holding that the Taxpayer failed to withhold tax.

- ▶ On appeal by the Taxpayer, the first appellate authority and the Income Tax Appellate Tribunal (ITAT) accepted the Taxpayer's contentions and deleted the disallowance. Aggrieved by the ITAT's ruling, the Tax Authority preferred an appeal before the HC.

HC's ruling

The HC held that the discounting charges were not in the nature of 'interest', attracting withholding obligation, for the following reasons:

- ▶ Payment of 'interest' presupposes borrowing of money or incurring of debt. Discounting of BEs does not involve borrowing of money or incurring of debt. The BEs were acquired by the purchaser at a discounted price and there was no debt or obligation incurred by the Taxpayer in favor of the purchaser of the BEs.
- ▶ The HC noted, with approval, the following reasoning adopted by the ITAT in allowing the Taxpayer's claim:
 - ▶ The definition of 'interest' in the Interest Tax Act^[1] specifically includes discount on promissory notes and BEs drawn or made in India. Such extended coverage is absent in the ITL and the DTAA definition of 'interest' which supports that but, for such specific reference, 'interest' does not include discounting charges within its scope.

^[1] The Interest Tax Act of 1974 had levied special tax on interest payments. The said Act has since been deleted w.e.f 31 March 1985. As per Section 2(7) of the Interest Tax Act, 'interest' means interest as loans and advances made in India and includes: (a.) Commitment charges on unutilized portion of any credit sanctioned for being availed of in India. (b.) Discount on promissory notes and BEs drawn or made in India.

- ▶ Circular No. 65 dated 2 September 1971, issued by the Central Board of Direct Taxes (CBDT), clarified that, in cases of discounting of usance bill/BEs, the net payment made by the bank to the drawer of the BEs is in nature of a price paid for purchase of BEs. This circular clarified that discount amount cannot be regarded as 'interest' and, therefore, no tax is required to be deducted at source by the drawer.
- ▶ As per the Supreme Court (SC) decision in the case of Vijay Ship Breaking Corpn. v CIT [219 CTR 639], there is no withholding obligation for the taxpayer if the amount is not chargeable to tax in India.
- ▶ The discounting charges were not in the nature of interest paid. Rather, after deducting discount, SingCo received the net amount of the BEs accepted by the purchaser. As SingCo does not have a PE in India, it is not liable to tax in respect of such discount earned by it and, hence, the Taxpayer is not under obligation to deduct tax at source under Section 195 of the ITL.
- ▶ The HC also referred to the CBDT Circular No. 647 dated 22 March 1993^[2] and noted that, as per clarification provided by this circular, the difference between the issue price and face value of commercial papers (CPs) and certificates of deposits (CDs) is to be treated as 'discount allowed' and not as 'interest' and no tax is required to be deducted on such discount.

^[2] In this circular, the CBDT had dealt with CDs/CPs which are negotiable instruments in the nature of usance promissory notes and are traded in the secondary market. Such instruments are issued at a discount on their face value and are freely transferable by endorsement and delivery.

- ▶ The HC eventually concluded that no substantial question of law arises since the matter is settled by the SC decision (*supra*) as also the CBDT circulars and the appeal was dismissed.

Comments

This ruling provides guidance that discounting charges of BEs do not represent 'interest' and, hence, do not attract withholding obligation for the taxpayer. Incidentally, the Authority for Advance Rulings, in the case of ABC International Inc.,^[3] on identical facts, reached a similar conclusion.

^[3] AAR No. 840 of 2010 dated 3 May 2011

Our offices

Ahmedabad

2nd floor, Shivalik Ishaan
Near CN Vidhyalaya Ambawadi
Ahmedabad - 380 015
Tel: + 91 79 6608 3800
Fax: + 91 79 6608 3900

Bengaluru

"UB City", Canberra Block
12th & 13th floor
No.24 Vittal Mallya Road
Bengaluru - 560 001
Tel: + 91 80 4027 5000
+ 91 80 6727 5000
Fax: + 91 80 2210 6000 (12th floor)
+ 91 80 2224 0695 (13th floor)

Chennai

TPL House, 2nd floor
No. 3 Cenotaph Road Teynampet
Chennai - 600 018
Tel: + 91 44 6632 8400
Fax: + 91 44 2431 1450

Hyderabad

205, 2nd floor
Ashoka Bhoopal Chambers
Sardar Patel Road
Secunderabad - 500 003
Tel: + 91 40 6627 4000
Fax: + 91 40 2789 8851

Oval Office, 18, iLabs Centre
HITECH City, Madhapur
Hyderabad - 500081
Tel: + 91 40 6736 2000
Fax: + 91 40 6736 2200

Kochi

9th Floor, Abad Nucleus
NH-49, Maradu PO
Kochi -682304
Tel: +91 484 3044000
Fax: +91 484 2705393

Kolkata

22 Camac Street
Block 'C', 3rd floor
Kolkata - 700 016
Tel: + 91 33 6615 3400
Fax: + 91 33 2281 7750

Mumbai

14th floor, The Ruby,
Dadar, Mumbai - 400 028.
Tel: + 91 22 6192 0000
Fax: + 91 22 6192 1000

6th Floor, Express Towers,
Nariman Point,
Mumbai - 400 021
Tel: + 91 22 6657 9200
Fax: + 91 22 2287 6401

Block B-2, 5th Floor
Nirlon Knowledge Park
Off. Western Express Highway
Goregaon (E), Mumbai - 400 063.
Tel: + 91 22 6749 8000
Fax: + 91 22 6749 8200

NCR

Golf View Corporate Tower B
Near DLF Golf Course Sector 42
Gurgaon - 122002
Tel: + 91 124 464 4000
Fax: + 91 124 464 4050

6th floor, HT House
18-20 Kasturba Gandhi Marg
New Delhi - 110 001
Tel: + 91 11 4363 3000
Fax: + 91 11 4363 3200

4th & 5th Floor, Plot No 2B, Tower 2,
Sector 126, NOIDA 201 304
Gautam Budh Nagar, U.P. India
Tel: + 91 120 671 7000
Fax: + 91 120 671 7171

Pune

C-401, 4th floor Panchshil Tech Park
Yerwada (Near Don Bosco School)
Pune - 411 006
Tel: + 91 20 6603 6000
Fax: + 91 20 6601 5900

Ernst & Young Pvt. Ltd.

Assurance | Tax | Transactions | Advisory

About Ernst & Young

Ernst & Young is a global leader in assurance, tax, transaction and advisory services. Worldwide, our 141,000 people are united by our shared values and an unwavering commitment to quality. We make a difference by helping our people, our clients and our wider communities achieve their potential.

For more information, please visit

www.ey.com/india

Ernst & Young refers to the global organization of member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. Ernst & Young Private Limited is one of the Indian client serving member firms of Ernst & Young Global Limited.

Ernst & Young Pvt. Ltd is a company registered under the Companies Act, 1956 having its registered office at 22, Camac Street, Block C, 3rd Floor, Kolkata- 700016

© 2011 Ernst & Young Pvt. Ltd.
All Rights Reserved.

Information in this publication is intended to provide only a general outline of the subjects covered. It should neither be regarded as comprehensive nor sufficient for making decisions, nor should it be used in place of professional advice. Ernst & Young Pvt. Ltd. accepts no responsibility for any loss arising from any action taken or not taken by anyone using this material.