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SITG No. 302

Whether different rate of tax for domestic and foreign taxpayers constitute discrimination under non-discrimination clause?

**The Principle of Non-Discrimination
in Tax Treaties Executed by India**

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Introduction

- ❖ The non-discrimination clause in India's tax treaties ensures that no discrimination is done on the basis of nationality, PE status, expense deductibility and ownership of enterprises.
- ❖ In simple terms, it means a country cannot impose higher taxes, tougher rules, or harsher conditions on someone just because they have different nationality/PE status/ownership. The idea is to keep taxation fair and neutral across borders.
- ❖ This SITG walks you through how this clause works, what India's treaties say about it, and where the key differences lie across different treaty partners.

OECD's Article 24: The Six Paragraph Structure

- ❖ Article 24 of the OECD Model Convention is the blueprint for non-discrimination in tax treaties. It addresses discrimination across four key areas — nationality, permanent establishments, deductibility of payments, and foreign ownership — and most Indian treaties follow this structure, with some meaningful variations.

Para	Subject	Who is Protected?	Key Test
1	Nationality-based	Foreign nationals vs. domestic nationals	Same circumstances; nationality as connecting factor
2	Stateless persons	Stateless residents	Not more burdened than nationals of residence state
3	PE-related	PE of foreign enterprise	Not taxed 'less favourably' than similar domestic enterprise
4	Expense-related	Resident payer making payments to non-residents	'Under the same conditions' as payments to residents
5	Ownership-related	Resident enterprise with foreign shareholders	Not more burdened than comparable domestically-owned enterprise
6	Taxes covered	All taxpayers	Applies to taxes of every kind

Whether different tax rates for resident and non-resident constitutes discrimination?

It is important to understand that the non-discrimination clause does not prohibit different tax rates based on whether a person is a resident or non-resident. **When it comes to tax rates, the clause only protects against discrimination based on nationality.** Residence becomes relevant **only in the context of PE taxation and deductibility of expenses.** So, a higher tax rate for non-residents is not, by itself, a violation of the non-discrimination clause.

Let's now discuss various kinds of non-discrimination discussed under model convention.

Paragraph 1: Nationality Non-Discrimination

- ❖ *“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.”*
- ❖ Paragraph 1 ensures that nationals of one treaty country are not taxed more harshly in the other country compared to its own nationals in similar circumstances. The focus is on nationality, not residence, and the protection extends even to persons not resident in either country.
- ❖ The key condition is that the persons being compared must be in "same circumstances", both legally and factually.
- ❖ In *Credit Lyonnais v. DCIT* (2005) 94 ITD 401 (Mumbai ITAT), Sections 80R and 80RRA, which allowed deductions only for Indian citizens, were held discriminatory against foreign nationals. These provisions were subsequently withdrawn from 1 April 2005.

Paragraph 3: PE Related Non-Discrimination

- ❖ *“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.*
- ❖ Paragraph 3 ensures that a permanent establishment of a foreign enterprise is not taxed less favourably than a domestic enterprise carrying on the same activities. The comparison is based on the nature of activities, not the legal form of the entity.
- ❖ Importantly, this protection covers only "taxation" and not procedural or compliance requirements. Additional reporting obligations, transfer pricing documentation, or consolidation rules imposed on a PE are therefore not considered discriminatory under this paragraph.
- ❖ India has reserved the right to tax foreign companies, including PEs, at a higher rate than domestic companies. This is codified in the Explanation 1 to Section 90 of the Income-tax Act, 1961, which clarifies that a higher rate for foreign companies does not amount to less favourable treatment.

Paragraph 3: PE Related Non-Discrimination

- ❖ In *Metchem Canada Inc. v. DCIT* [99 TTJ 702], the Mumbai ITAT held that Section 44C, which caps head office expense deductions for PEs at 5% of adjusted total income, was discriminatory since no such restriction applied to domestic companies. The treaty provision was held to override domestic law.
- ❖ However, certain Indian treaties including those with the USA, Germany, and Sweden specifically provide that Article 7(3) prevails over PE non-discrimination, thereby preserving domestic restrictions on expense deductions.
- ❖ Since the India-Canada DTAA contained no such qualification, the ruling went in favour of the taxpayer.

Paragraph 4: Expense Related Non-Discrimination

- ❖ *“Interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for 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.”*
- ❖ Paragraph 4 ensures that payments such as interest, royalties, and other disbursements made to a non-resident are deductible under the same conditions as if made to a resident. The focus is on protecting the payer from being denied deductions simply because the recipient happens to be a non-resident.
- ❖ In CIT v. Herbalife International India Pvt. Ltd. (2016) 384 ITR 276, the Delhi High Court held that Section 40(a)(i) was discriminatory. It disallowed payments to non-residents where tax was not withheld, while no such restriction existed for payments to residents, and was therefore held to violate the non-discrimination clause of the India-USA DTAA.
- ❖ The issue was subsequently addressed by inserting Section 40(a)(ia), which extended a similar disallowance to resident payments as well, thereby restoring parity between the two.

Paragraph 4: Expense Related Non-Discrimination

- ❖ Thereafter, in the recent case *Linkedin Technology Information (P.) Ltd v. PCIT [2026] 182 taxmann.com 472 (Delhi – Trib.)* it was held that disallowing 100% of expense in case of payment to non-residents as against only 30% disallowance of expense in case of payment to residents is discriminatory in nature and the matter was ruled in favour of the assessee.

Paragraph 6: Taxes Covered

- ❖ *“The provisions of this Article shall, notwithstanding the provisions of Article 2, apply to taxes of every kind and description.”*
- ❖ Paragraph 6 extends the non-discrimination protection to taxes of every kind and description, going beyond the income and capital taxes covered under Article 2.
- ❖ This prevents discriminatory treatment from being introduced through indirect taxes, stamp duties, or other fiscal levies outside the treaty's primary scope.
- ❖ However, many Indian DTAA's narrow this back by defining "taxation" to mean only taxes covered under the Convention. In such treaties, including those with the UK, Singapore, and UAE, the broader protection under Paragraph 6 does not apply.

Applicability of OECD Model Convention

- ❖ The OECD Model Convention carries no binding legal force, it is a template, published as a recommendation on how countries should structure their bilateral tax treaties. No country is legally obligated to adopt, follow, or incorporate any specific provision from it.
- ❖ **Moreover, India is not a member of OECD but just an observer and such conventions are anyway not legally binding on Indian DTAA's.**
- ❖ During DTAA negotiations, the countries use the OECD MC merely as a starting point. Either country can accept a provision as drafted, modify it, omit it entirely, expand it, or restrict it to a narrower scope.
- ❖ What ultimately binds countries is only the signed treaty, which becomes binding in international law through the Vienna Convention on the Law of Treaties. The OECD MC itself never becomes binding, the signed DTAA is always the governing instrument.
- ❖ In light of the above, the table on the next slide highlights which of the five important paragraphs of Article 24 have been adopted in some of India's major DTAA's.

Position Across Major DTAs

Note: 'Yes' indicates the respective paragraph is included; 'No' indicates it is excluded.

Treaty Partner	Article No.	Nationality (Para 1)	Stateless (Para 2)	PE (Para 3)	Expense (Para 4)	Ownership (Para 5)
USA	Art. 26	Yes	No	Yes	Yes	Yes
UK	Art. 24	Yes	No	Yes	No	Yes
Germany	Art. 24	Yes	No	Yes	Yes	Yes
France	Art. 26	Yes	No	Yes	Yes	Yes
Japan	Art. 24	Yes	No	Yes	Yes	Yes
Singapore	Art. 24	Yes	No	Yes	No	Yes
Australia	Art. 24	Yes	No	Yes	Yes	Yes
China	Art. 23	Yes	No	Yes	Yes	Yes
Netherlands	Art. 24	Yes	No	Yes	Yes	Yes
Canada	Art. 24	Yes	No	Yes	No	Yes
UAE	Art. 25	Yes	No	Yes	No	Yes
Romania	Art. 24	Yes	Yes	Yes	No	Yes
Latvia	Art. 24	Yes	Yes	Yes	No	Yes
Oman	N/A	No	No	No	No	No

SIMPLE GUIDE TO DTAA NON-DISCRIMINATION (FOR INDIA)

INDIA DTAA NON-DISCRIMINATION: CORE PRINCIPLE IS FAIRNESS

NATIONALITY: NO PENALTY FOR BEING FOREIGNER



Indian and Foreign individuals working similarly in India are taxed the same. No higher taxes just because of your nationality.



EXPENSES ARE DEDUCTIBLE



EXPENSES ARE DEDUCTIBLE



Payments (like interest, royalties) made by an Indian company to its foreign partner are deductible. India must allow these costs just as if paid to a local partner.

Branch Office of Country B Company



FOREIGN COMPANIES IN INDIA (PE)

The Indian office of a foreign company is taxed fairly. India will not tax it more heavily than a similar Indian company doing the same business.



ARE DIFFERENT RATES DISCRIMINATORY?

1. TAX RATE DIFFERENCES (e.g., 30% vs. 40%):

- A simple difference in tax rates for residents vs. non-residents is NOT considered discrimination under standard DTAA. It's about "similar circumstances".
- Residents often get personal allowances or lower bands; non-residents may not. This is normal and allowed.

2. WITHHOLDING TAX (TDS) RATES:

- Withholding tax is a way of collecting tax, not the tax rate itself. Setting a specific-rate (e.g., 10%) for payments to non-residents is a common and permitted mechanism. It's not discrimination, it's just a collection method.

3. DTAA PROTECTION:

- The Non-Discrimination Clause ensures that IF a non-resident meets all conditions and is in the same circumstances, they won't face extra burden. It is NOT a promise of the lowest possible rate.



FOREIGN-OWNED INDIAN BUSINESSES

Indian companies owned by foreign investors are not penalized. They cannot be subject to higher or more burdensome taxes than other local Indian businesses.



FAQs

Q1. Section 40(a)(i) disallowed 100% expense to non-residents where TDS was not deducted, but in case of resident it is restricted to 30%. Is this discriminatory?

A. Yes. In the recent case *LinkedIn Technology Information (P.) Ltd v. PCIT [2026]182 taxmann.com 472 (Delhi – Trib.)* it was held that disallowing 100% of expense in case of payment to non-residents as against only 30% disallowance of expense in case of payment to residents is discriminatory in nature and the matter was ruled in favour of the assessee.

Q2. Foreign companies are taxed at 40% while domestic companies pay 25-30%. Does this violate the non-discrimination clause?

A. No. This is settled across decades of litigation. The Explanation 1 to Section 90, inserted retrospectively from 01.04.1962, expressly states that a higher rate for foreign companies is not less favourable treatment. The Mumbai ITAT in *BNP Paribas (2024) 207 ITD 532* reaffirmed this position for the latest assessment year, consistent with every prior year.

FAQs

Q3. Can a PE claim tax incentives available to domestic enterprises?

A. Yes. The Ahmedabad ITAT Special Bench in Rajeev Gajwani (2011) 129 ITD 145 held that denying an export deduction under Section 80HHE to a PE carrying on the same activity as a domestic enterprise violates Article 26(2). The treaty overrides the domestic restriction.

Q4. The 182-day rule for determining residential status under Explanation 1(a) to Section 6(1)(c) is available only to Indian citizens. A foreign national leaving India for employment gets no such benefit and becomes a resident. Is this discriminatory?

A. Yes, the legal basis is sound. A foreign national leaving India for employment is in the same circumstances as an Indian citizen doing the same. Extending the 182-day threshold only to Indian citizens creates a nationality-based differential that falls squarely within Paragraph 1 of the non-discrimination clause. The matter is not yet judicially decided.

FAQs

Q5. Section 44C caps head office expense deductions for PEs at 5% of adjusted total income. No such restriction applies to Indian companies. Is this discriminatory?

A. It depends on the treaty. Where the DTAA does not contain a specific carve-out preserving Article 7(3), Section 44C is discriminatory, as held in *Metchem Canada*. However, treaties with the USA, Germany, Spain, Sweden, Finland, and Cyprus specifically preserve domestic restrictions on PE expense deductions. In those cases, Section 44C stands.

Q6. Can a PE be taxed on gross receipts when a comparable Indian enterprise would be taxed on net profits?

A. No, this is discriminatory. The Delhi ITAT in *Rolls Royce Industrial Power (2010) 42 SOT 264* held that taxing a PE on a gross basis while a domestic enterprise in the same activity is taxed on net profits violates PE non-discrimination. Income must be computed on a net basis.

FAQs

Q7. A PE of a foreign bank was taxed at 48% while domestic banks were taxed at 35%. The bank argued this violated the non-discrimination clause. Was it correct?

A. No. The Mumbai ITAT in Chohung Bank (2006) 102 ITD 45 held that a foreign bank branch and a domestic Indian bank are not in "same circumstances." Domestic banks carry regulatory obligations, such as priority sector lending, that do not apply to foreign branches. Since comparability was not established, the higher rate was not discriminatory.

Q8. A French bank claimed the non-discrimination clause entitled it to the Section 80M deduction available only to domestic companies. Was this right?

A. No. The Mumbai ITAT in Credit Lyonnais (2005) 94 ITD 401 held that the Section 80M distinction is based **on residence, not nationality**. Since even a French company could qualify as a domestic company by making the requisite arrangements in India, the denial was not nationality-based and the non-discrimination clause was not attracted.

FAQs

Q9. Section 40(a)(i) was invoked against an Indian company for payments to a Japanese affiliate, even though the recipient had declared the income abroad. Was this discriminatory?

A. Yes. The Delhi High Court in *Mitsubishi Corporation India (2024) 463 ITR 335* held that non-residency of the payee alone cannot justify a disallowance where comparable domestic payments would not face the same consequence. The matter was remanded with a direction to apply the non-discrimination standard.

Q10. Can the non-discrimination clause be used to challenge a wrong or excessive assessment by the tax authority?

A. No. The Mumbai ITAT in *Nurally Mamade Hussene (2022) 198 ITD 278* held that non-discrimination applies only where the adverse treatment is caused by the taxpayer's nationality. A wrong assessment does not become discriminatory simply because the taxpayer is a foreign national. The same mistake would be made against any taxpayer in the same position.

Our Comments

- ❖ It is important to understand that the obligation to establish that a domestic tax provision violates the non-discrimination Article rests squarely on the taxpayer. This involves demonstrating:
 - (i) that the relevant DTAA contains a non-discrimination provision;
 - (ii) that the provision applies to the taxpayer's circumstances;
 - (iii) that the domestic law provision in question imposes more burdensome taxation (or connected requirements); and
 - (iv) that the discriminatory treatment is based on nationality, PE status, or ownership, as applicable.

- ❖ Even though Explanation 1 to Section 90 explicitly states that a higher tax rate for foreign companies does not constitute less favourable treatment, can a non-resident still argue that Section 90(2), which allows the taxpayer to opt for whichever of the DTAA or domestic law is more beneficial, entitles them to the lower tax rate applicable to domestic companies?

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