

January 9, 2013
2013-007

**India – High Court Allows
Hypothetical Tax as
Deduction from Income**

by KPMG, India (a KPMG
International member firm)

flash International Executive Alert

A Publication for Global Mobility and Tax Professionals by KPMG's International Executive Services Practice

In India, the Bombay High Court ("High Court"), in the case of Mr. Jaydev H. Raja ("the taxpayer"), recently confirmed the permissibility of a reduction (withholding or deduction) in respect of the hypothetical tax from a taxpayer's salary.¹ It has therefore held that only the differential tax actually borne by the employer after the adjustment of hypothetical tax is liable to be treated as an "addition" to taxable income.

Some Context

Employers of globally mobile employees often enter into a 'tax equalization agreement' agreeing to bear the incremental tax costs arising from an international assignment. A tax equalization agreement protects international employees from additional tax costs arising in multiple tax jurisdictions. As a part of this agreement, the home country tax that the employee would normally bear had he remained in his home country (also commonly referred to as 'hypothetical tax') is deducted or withheld from the employee's salary. Thereafter, the actual taxes (in home and host countries) are paid by the employer (partially funded by the hypothetical taxes deducted from the employee's salary).

Facts of the Case

- The taxpayer was an individual who was employed with a major U.S. soft-drinks company (employer) and was in India on assignment.
- Under the tax equalization policy framed by his employer, the tax liability arising to the taxpayer on account of the international assignment was to be borne by the employer. The taxpayer was required to reimburse the employer for the hypothetical tax, which is that part of his total tax liability he would have paid had he continued working in the United States.
- The taxpayer, due to the fact that he had salary income taxable in India, included the tax paid by the employer and reduced the hypothetical tax borne by him.
- Assessing Officer ("AO") and the Commissioner of Income-tax (Appeals) ("CIT(A)") held that a deduction was not expressly allowed under the provisions of the Income-tax Act, 1961 ("the Act") in respect of the hypothetical tax. The deduction of hypothetical tax was an application of income after its accrual.
- The Income-tax Appellate Tribunal ("the Tribunal") upheld the claim of the taxpayer for the deduction of hypothetical tax as the tax equalization agreement provided for the employer to bear only the incremental tax liability arising from the Indian assignment after the employer had recovered the hypothetical tax. The taxpayer, in effect, had borne the tax burden to the extent of the hypothetical tax and had correctly subjected to tax only the amount of tax actually borne by the employer.

- The Tribunal also recorded that confusion arose because the entire actual taxes paid by the employer was added to income and thereafter the tax borne by the employee (hypothetical tax) was withheld from income.
- Further, the taxpayer was also provided a rent-free accommodation by the employer. The employer had rented this property and also paid over a security deposit for the same. The value of the rent-free accommodation was subjected to tax as per the rules prescribed for such valuation. The AO added the notional interest on the security deposit to the fair rental value considered for taxation. The CIT(A) also affirmed this addition. However, the Tribunal relying on earlier decisions deleted the said addition.

Issues before the High Court

- Whether the hypothetical tax borne by the employee was not 'salary'.
- Whether notional interest on the security deposit paid over by the employer to provide a rent-free accommodation to the employee is required to be considered for computing the perquisite value of such accommodation.

High Court's Ruling

Under the terms of the tax equalization agreement, the employer had agreed to bear Indian taxes on the assignment, but only to the extent this exceeded the hypothetical home country tax liability. Therefore, only the incremental tax liability actually borne by the employer accrued as salary to the taxpayer. The hypothetical tax paid by the taxpayer could not therefore be added to the taxpayer's income.

Regarding the valuation of the accommodation perquisite, the High Court commented that as the Tribunal has already allowed the claim of the taxpayer by relying on the earlier Bombay High Court's decision itself, the said issue cannot be answered again by the High Court.

KPMG Note

The High Court's ruling has re-affirmed the position that only the incremental tax liability actually borne by the employer on behalf of an employee ought to be taxed as salary. The hypothetical tax that is withheld or deducted from the employee's salary represents the tax costs to be borne by the employee and hence cannot be added to the income of the employee.

Footnote:

- 1 *CIT v. Jaydev H. Raja* (ITA No. 87 of 2000 for Assessment Year (AY 1994-95).

This article originally appeared in "High Court Confirms Allowability of Hypothetical Tax as a Deduction from Taxable Income" from *KPMG Flash News* (19 December 2012), a publication of the KPMG International member firm in India. It is adapted here in *Flash International Executive Alert*, with permission.

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