

## **Recent Decisions on disallowance u/s 40(a)(i)**

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- **Goldcrest Exports vs. ITO [2010] 42 SOT 1 (MUM.)**

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2. The first issue is disallowance of Rs. 38,41,257 under section 40(a) of the Income-tax Act, which was in respect of the payment of compensation under the arbitration award to non-resident company. The facts pertaining to the issue which reveal from the record are as under.

3. The assessee-firm is engaged in the business of export & import as well as trading in different commodities. The assessee had made the provision of Rs. 38,41,257 in respect of the compensation to be paid to foreign company namely M/s. Swissgen NV of London (UK) and claimed the same as an expenditure in the profit and loss account. The assessee has entered into a contract for supply of Indian Natural Whitish Sesame Seeds to M/s. Swissgen NV London, UK (in short 'foreign buyer'). Two different contracts were entered into; One for 95 MT and another for 190 MT. One M/s. Radhasons International was broker through whom the contracts for sale were entered into by the assessee with the foreign buyer at the price of US \$540 per MT. The assessee repudiated the contract on the ground that the seller did not obtain the export contract duly signed by the buyer and contract was merely signed by the broker. There was sum correspondence between foreign buyer and assessee-firm. The foreign buyer invoking arbitration clause and proceeded with FOSFA arbitration. The foreign buyer appointed an Arbitrator namely Mr. Derek Marshal and also asked the assessee to appoint the Arbitrator within 14 days. The assessee did not opt to appoint Arbitrator. The foreign buyer claimed the compensation from the assessee through the arbitration proceedings to the extent of US \$ 81,937.50. The Arbitrator passed the award determining the claim of the foreign buyer against the assessee of US \$ 81,225, payable with interest at the rate of 5 per cent per annum from 3-11-2003 till the date of payment of awarded amount. The claim of the damages was base on the ruling rate of specified dates minus the contract price. The assessee contended that damages were nothing but difference in price ruling on the

date of non-fulfilment of the contracts and contract prices. The assessee, therefore, claimed the same under section 37(1) of the Act. The Assessing Officer rejected the claim of the assessee by giving the following reasons :—

- “(i) The act of compensation receivable for breach of contract cannot be equated with ‘operations which are confined to the purchase of goods in India for the purpose of export’.
- (ii) DTAA between India and UK does not define the term ‘Business Profits’ which is the subject-matter of taxability under Article-7. The assessee has not brought any material on record to demonstrate that in the hands of foreign buyer the compensation amount would be business profits so that recourse to Article-7 may be allowed.
- (iii) DTAA between U.K. and India will apply only to the Resident of one or more country. Nothing is brought on record to suggest that M/s. Swissgen N. V. London, UK is a Resident of U.K.
- (iv) The compensation is taxable in India under section 9(1)(i) since it is an income deemed to accrue or arise in India.
- (v) The assessee was required to deduct TDS under section 195 on provision for compensation made in the Books for assessment year 2005-06, which it has not done.”

4. Assessee challenged the disallowance before the Learned CIT(A) but without success who confirmed the same by giving following reasons:—

“2.3 I have considered the submission of the Appellant as well as the Asstt. order. The perusal of the Arbitration Award shows that the foreign buyer had contracted to purchase through Radhasons International. From the submissions made by the Appellant it could be seen that the Appellant was to pay 1 per cent commission to Radhasons International in Mumbai. The Appellant is conveniently silent about the role played by Radhasons International. The status of Radhasons International as to its being a resident or a non-resident had not been clarified as to determine whether or not the foreign buyer had a permanent establishment through its agent Radhasons International. In view of the above, the Appellant’s proposition that compensation paid cannot be held to accrue or arise in India is not acceptable. The compensation paid cannot be equated with the purchase of goods in India for the purpose of export as in the instant case there was no actual purchase of goods. The compensation does not fall in the exception provided under Explanation 1(b). Regarding the residential status of the foreign party, just filing a downloaded copy of a Web page does not establish the same and as such the reliance placed in the DTAA between India and UK becomes

meaningless. Considering the above, the Appellant was liable to deduct tax under section 195 on the compensation payable to the foreign party, which has been debited to the P&L A/c. The Assessing Officer is very much justified in disallowing the compensation of Rs. 38,41,257 under section 40(a). Accordingly, this ground of appeal is dismissed.”

5. Now, the assessee is in appeal before us.

6. We have heard the rival submissions of the parties and also perused the records as well as the paper book filed by the assessee. We have also considered the precedents cited by both the parties. The Learned Counsel argues that compensation paid by the assessee was in respect of its trading contract with M/s. Swissgen NV London, UK. It is argued that the arbitration award was passed in financial year 2004-05 more particularly on 13-8-2004 and the same was communicated to the assessee. The assessee challenged the said award in the Hon'ble High Court without success. The Learned Counsel also referred to the copy of the Arbitration award which is placed at page Nos. 19 to 28 of the paper book. It is argued that, at the first instance, provisions of section 195(1) are not applicable for deducting the tax at source as the arbitration award was passed in UK and it cannot be said that the income has accrued to the foreign buyer to whom the payment was made. The Learned Counsel further argued that as per the provisions of DTAA between the India & UK, the compensation payable otherwise is also not taxable for the reason that the foreign company has not Permanent Establishment (in short 'PE') in India. He further submitted that as per Article 7.1 of the DTAA between India & UK, the compensation in the nature of the business profit and M/s. Swissgen NV London, UK which is a non-resident company has no PE in India as per Article 5 of the DTAA. It is argued that M/s. Radhasons International is an 'independent broker'. He further pleaded that obligation to deduct tax at source under section 195(1) arise only when the income of the non-resident is chargeable to tax in India. The Learned Counsel relied on the following precedents/decisions :—

- (i) Van Oord ACZ India (P.) Ltd. v. CIT [2010] 189 Taxman 232 (Delhi);
- (ii) ITO (International Taxation) v. Prasad Production Ltd. [2010] 125 ITD 263 (Chennai)(SB);
- (iii) Mahindra & Mahindra Ltd. v. Dy. CIT [2009] 30 SOT 374 (Mum.)(SB);
- (iv) Royal Airways Ltd. v. Addl. DIT [2006] 98 ITD 259 (Delhi).

7. The Learned Counsel further argued that the Hon'ble Special Bench has already considered the decision of the Hon'ble High Court of Karnataka in the case of CIT (International Taxation) v. Samsung Electronics Co. Ltd.

[2010] 320 ITR 2091. It is argued that, so far as the interest element in the compensation is concerned the same is merged with the compensation and it loses its original character and assumes the character of judgment debt. For the said proposition, he relied on the decision of Hon'ble High Court of Bombay in the case of Islamic Investment Co. v. Union of India [2009] 265 ITR 2542. Per contra, the Learned D.R. supported the order of the Assessing Officer as well as the Learned CIT(A) and submitted that in the case of Samsung Electronics Ltd. (supra) it is held that whether the income of the non-resident made taxable in India or not cannot be determined by the assessee as the said authority has vested with the Assessing Officer under section 197 of the Act. He further argued that so far as the present assessment year is concerned, the nature of the liability was the contingent one and it was not the ascertained liability.

8. We have already elaborately discussed the facts pertaining to the issue in controversy before us. The Assessing Officer made a disallowance mainly on the reason that the assessee has not deducted the tax at source under section 195 of the Act, when the provision for compensation was made in the books of account and he made the disallowance under section 40(a) of the Act. It is clear from the reasons given by both the authorities that the nature of the liability to pay compensation whether it is a contingent or ascertained was not any of the reasons for disallowing the claim of the assessee. The disallowance is made only on the reason that as per the provisions of section 40(a) of the Act the assessee failed to deduct tax. As per the copy of the Arbitration Award filed on record, it is seen that the M/s. Swissgen NV London, UK is shown as foreign company in the arbitration award dated 13-8-2004. The arbitration award has not disputed by both the parties. As per the arguments of the Learned Counsel, M/s. Swissgen NV London, UK is a non-resident and has no PE in India. In this case, one broker namely M/s. Radhasons International was involved in the deal and it was an independent broker. The only reference of the DTAA in the assessment year is on the two points (i) assessee has not brought anything on record to demonstrate that the amount of the compensation would be the business profit within the meaning of article 7 of the DTAA between India & UK; and (ii) nothing is brought on record to suggest or prove that the foreign party is a Resident of UK and apart from that there is no discussion in the assessment order. The Learned CIT(A) was of the opinion that the status of the buyer namely M/s. Radhasons International whether it was a resident or non-resident had not been clarified. In our opinion, both the parties have

not understood the issue in a proper prospective. So far as character of the compensation is concerned, in our opinion, it is a business profit and is covered under Article 7 of DTAA of UK and India as it is arising out of the trading contract entered into by the assessee and M/s. Swisssen NV London, UK. It appears that the said contract was through one broker M/s. Radhasons International, Mumbai.

9. The next issue is to be determined whether there is any PE as per Article 5 of DTAA between India and UK. Nowhere it is a case of the Assessing Officer as well as CIT(A) that Radhasons International was dependent broker. As per the facts on record, a contract was only supply of goods in India and nothing is there on record to suggest that M/s. Radhasons International was the dependent agent of the foreign buyer. The foreign buyer has no PE in India. As per Article 5(5) of DTAA, even if any business is carried out through a broker or general commission agent or any other agent of an independent status, then it cannot be said that the non-resident has PE in India. We, therefore, hold that as M/s. Swisssen NV London, UK has no PE in India and hence the compensation awarded under arbitration award was not taxable in India. So far as the decision of Samsung Electronics Ltd.'s case (supra) is concerned, contrary view is taken by Hon'ble Delhi High Court in case of Van Oord ACZ India (P.) Ltd. (supra). Moreover, the Special Bench of the Tribunal in the case of Prasad Production Ltd. (supra) has considered the decision of the Hon'ble Karnataka High Court in the case of Samsung Electronics Ltd. (supra). We, therefore, hold that there is no obligation on the assessee to deduct the tax under section 195(1) of the Act. It is true that there is an element of the interest in the amount awarded, but this issue is also covered in favour of the assessee by the decision of Hon'ble jurisdictional High Court in the case of Islamic Investment Co. (supra). In the said case the Hon'ble High Court has held that the amount payable to the non-resident in view of the decree or arbitration award loses its original character and assumes the character of a judgment debt. In sum and substance, interest partake the character of the compensation. We, therefore, hold that for the reasons given hereinabove, there was no justification for disallowing amount of the compensation claimed by the assessee on the reason for non-deduction of the tax. We, therefore, delete the addition and allow the ground taken by the assessee.

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- **Central Bank of India vs. DCIT (ITAT Mumbai)**

ITA No. 4155/M/2003 (Assessment Year 1997-98), ITA No. 4156/M/2003 (Assessment Year 1998-99), ITA No. 4157/M/2003 (Assessment Year 1999-2000), decided on September 24, 2010.

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These appeals by the assessee are directed against orders dated 27.3.2003, 31.3.2003 and 31.3.2003 for assessment years 1997-98 to 1999-2000 respectively. As the disputes raised in these appeals are identical, these are being disposed off by a single consolidated order for the sake of convenience. The identical disputes raised relate to disallowance of expenditure on account of payments to Master Card and VISA, USA and disallowance of bad debt. Though the assessee in A.Y. 1997-98 has raised some other grounds also, only the two grounds mentioned above have been cleared for litigation before the Tribunal by COD and therefore only these grounds are admitted for adjudication.

The first dispute which is common in all the appeals is regarding disallowance of bad debt. The claim of bad debt is allowable under the provisions of clause (vii) and (vii-a) of section 36(1). These provisions are reproduced below as a ready reference :

"(vii) subject to the provisions of sub-section (2) the amount of any bad debt or part thereof which is written off as irrecoverable in the accounts of the assessee for the previous year.

Provided that in case of an assessee to which clause (vii-a) applies, the amount of deduction relating to any such debt or part thereof shall be limited to the amount by which such debt or part thereof exceeds the credit balance in the provision for bad and doubtful debts account made under that clause.

Explanation - for the purpose of this clause, any debt or part thereof written off as irrecoverable in the accounts of the assessee shall not include any provisions for bad and doubtful debts made in the accounts of the assessee.

(vii-a) In respect of any provisions for bad and doubtful debts made by a scheduled bank not being a bank incorporated by or under the laws of a country outside the India or a non-scheduled bank, an amount not exceeding 5% of the total income (computed before making any deduction) under this clause and Chapter VIA and an amount not exceeding 10% of the aggregate average advances made by the rural branches of such bank computed in the prescribed manner.

Thus in case of scheduled bank, 5% of total income is admissible as bad debt and further provision calculated with reference to the aggregate advances made by the rural branch of the bank is also allowable. The assessee submitted that the claim of bad debt in these years mostly related to non-rural advances and therefore these debts should not be adjusted against the provisions for bad debt credited in respect of rural advances under the proviso to clause (vii). Accordingly it was argued that bad debts exceeding general provisions for bad debt should be allowed as deduction without adjusting the same against the provisions for rural bad debt. The AO however did not accept the arguments advanced and observed that clause (vii) of section 36(1) did not make any distinction between general provisions for bad debt and provisions for bad debt in respect of rural advances. Therefore the AO held that aggregate provision for rural and non-rural debts has to be considered for the purpose of proviso to clause (vii) and only bad debt which is in excess of the credit balance in the provision account will be allowed. In appeal CIT(A) confirmed the order of AO aggrieved by which the assessee is in appeal before the tribunal.

Before us the Learned AR of the assessee at the very outset pointed out that this issue was covered by the decision of tribunal in assessee's own case in assessment year 1989-90 in ITA No. 3602/M/93 and also by the order of tribunal in the subsequent orders. The Learned DR fairly conceded that the issue was covered.

We have perused the records as well as the decision of the tribunal in assessee's own case in assessment year 1989-90 (supra) carefully. Tribunal in the said year followed the decision of the special bench of Cochin tribunal in case of DCIT v. Catholic Syrian Bank Ltd. (88 ITD 185) and decided the issue in favour of the assessee. The special bench in case of Catholic Syrian Bank Ltd. (supra) had noted that the provisions of clause (vii) apply only to rural advances by a bank as clarified by the CBDT vide circular No. 258 dated 14.6.79 and 464 dated 18.7.98. The special bench accordingly held that in case amount of bad debt actually written off in the accounts of the bank represented only debts arising out of non-rural (urban advances), the allowance thereof in the assessment was not affected or controlled or limited in any way by the proviso to clause (vii) of section 36(1). Therefore only those debts which arose out of rural advance were to be limited in accordance with the said proviso. The assessee in that case was maintaining separate accounts for bad and doubtful debts other than the provisions for bad debt in respect of rural advances for which separate account was maintained. The tribunal therefore restored the matter to the AO for deciding the issue afresh after necessary examination. In the present case the order of CIT(A) shows that the claim of the assessee was that bad debts mostly related to non-rural advances. It is not clear how much of bad debt related to rural advances and how much to non-rural advances. We therefore, set aside the order of CIT(A) and restore the matter to the file of

AO for passing a fresh order after necessary examination in the light of decision of the special bench (supra) and after allowing opportunity of hearing to the assessee.

The second dispute which is also common in all the appeals is regarding allowability of claim of deduction on account of payments to Master Card and VISA Card, the two international credit card companies who were non-residents based in USA. The credit cards issued by the assessee bank were affiliated to VISA and Master Card, the two international agencies operating in these fields to facilitate credit card transactions of a large number of issuing banks. The two international agencies operated through highly advanced computer system which transferred data to and from the point where a credit card is issued in a shop or establishment to the central processing centre which may be based outside the India. The processing centres communicated with the member bank to confirm the validity of card, available credit etc. These agencies also provided customized software and hardware to the member bank to facilitate the process. These agencies charged the member bank for the various services provided. The amount charged depended upon the volume of transactions. The assessee during these years had made payments to these agencies on which no tax had been deducted at source. The AO therefore disallowed the claim of deduction on account of these payments under the provisions of section 40(a)(i). The said provisions as applicable in the relevant year are reproduced below as ready reference.

"40(a)(i) any interest (not being interest on a loan issued for public subscription before 1st day of April 1938), royalty, fees for technical services or other sum chargeable under this Act which is payable outside India on which tax had not been paid or deducted under Chapter XVII B.

Provided that where in respect of any such sum tax had been paid or deducted under Chapter XVII B in any subsequent year the sums shall be allowed as a deduction in computing the income of the previous year in which such tax had been paid or deducted.

Explanation - for the purpose of this sub-clause -

(A) royalty shall have the same meaning as in Explanation 1 to clause (vi) of sub-section (1) of section 9.

(B) Fees for technical services shall have the same meaning as in Explanation - 2 to clause (vii) of sub-section (1) of section 9.

The assessee disputed the decision of the AO and submitted before CIT(A) that income arising on this account to Master Card and VISA was not taxable in India as these international agencies were not having any



permanent establishment in India. The income had also arisen outside India. Therefore no tax was required to be deducted. CIT(A) however did not accept the contentions and observed that these US companies had acquired leased telephone lines in India and had also installed machinery and computers for their network in India without which it was not possible to provide the various services. These agencies were therefore, having permanent establishment in India through their networking computers and through leased telephone lines. Therefore the income received by them was taxable in India. CIT(A) accordingly confirmed the order of AO disallowing the claim of deduction on account of these payments as admittedly no tax had been deducted at source. Aggrieved by the decision of the CIT(A) the assessee is in appeal in all the three years.

Before us the Learned AR for the assessee argued that even if the income of Master Card and VISA was taxable in India no tax was required to be deducted in view of Article 26(3) of Double Taxation Avoidance Agreement (DTAA) between India and USA which protects the non-residents against any discrimination vis-a-vis residents. It was pointed out that clause (3) of Article 26 would be applicable in case of the assessee as per which, expenditure on account of payments to non-residents has to be allowed if the same was allowable if the payments were made to residents. It was pointed out that as per the provisions applicable for the relevant period, expenditure on account of payment to residents could not be disallowed on ground of non-deduction of tax at source. The said Article 26(3) is reproduced below as a ready reference :

"Article 26(3) :- Where the provisions of paragraph 1 of Article 19 (Associated Enterprises), paragraph - 7 of Article 11 (interest) of paragraph - 8 of Article 12 (royalties and fees for included service) apply, interest, royalties and other disbursements paid by a resident to a Contracting State to resident of other Contracting State shall for the purposes of determining taxable profit of the first mentioned resident, be deductible under the same conditions as if they had been paid to a resident of first mentioned state."

The Learned AR placed reliance on the decision of tribunal in case of Herbalife International India Pvt. Ltd. v. ACIT Range 12, New Delhi (109 ITD 450) in which it has been held that even if the payments were taxable in case of the non-residents no disallowance could be made on account of non-deduction of tax in view of article 26(3) of Indo US treaty. In the said case the American parent company had rendered services to the assessee which included data processing, accounting, financial and planning services in respect of its products in lieu of some administrative fees payable by the assessee. The tribunal in the said case noted that admittedly the exceptions set out in article 26(3) were not attracted and accordingly it was held that the assessee was entitled to protection under article 26(3) and no disallowance could be made as under the provisions at the relevant time no

disallowance could be made in case of payment to residents on the ground of non-deduction of tax at source. In the present case also, it was pointed out that the exception provided in section 26(3) were not applicable. It was submitted that paragraph 8 of Article 12 relating to royalties and fees for included services was relevant in case of the assessee and the said paragraph 8 applied only if the amount paid was more than the market value due to relationship between the parties. The assessee bank had no relationship with the payee and therefore paragraph 8 of Article 12 was not applicable and the case of the assessee was thus not covered by any exceptions provided in Article 26(3). The Learned DR on the other hand placed reliance on the order of CIT(A) and the AO.

We have perused the records and considered the rival contentions carefully. The dispute is regarding disallowance of deduction claimed by the assessee on account of payments made to Master Card and VISA Cards. The said payments were made by the assessee for services rendered by the foreign non-residents and disallowance has been made under section 40(a)(i) on the ground that no tax had been deducted at source. The case of the assessee is that said payments were not taxable in the hands of the payee non-residents as they did not have any permanent establishment in India. Alternatively it has also been argued that even if the amounts were taxable in the name of the non-resident, the deduction claimed on account of payments could not be disallowed in case of the assessee in view of the Article 26(3) of the Indo US Double Taxation Avoidable Agreement. We have perused the said article and are of the view that the said Article protects the interest of the non-residents vis-a-vis residents. The Article provides that payment made to the non-resident will be deductible under the same conditions as if the payment were made to a resident. The exceptions provided in the Article 26(3) are not applicable in case of assessee as paragraph 8 of the Article 12 does not apply to the assessee as there is no relationship between the assessee and the payee concerns. As per the provisions of section 40(a)(i) applicable for the relevant year no disallowance could be made respect of payments to the residents on the ground of non-deduction of tax at source. Therefore in view of the provisions of Article 26(3), no disallowance can be made in case of payments to the non-residents also even if the amount is found taxable in India in their hands. This view is supported by the decision of the Delhi Bench of the Tribunal in case of Herbal Life International India (109 ITD 450). The order of CIT(A) confirming the disallowance cannot therefore be upheld. We accordingly set aside the order of CIT(A) and allow the claim of the assessee.

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