

Sonata Information Technology Vs. Dy Cit

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Court : Income Tax Appellate Tribunal ITAT Mumbai

Decided On : Nov-11-2005

Reported in : (2006)7SOT465(Mum.)

Appellant : Sonata Information Technology

Respondent : Dy Cit

Judgement :

These are the cross appeals filed by assessee and revenue pertaining to the assessment year 2001-02. The same were heard together and therefore, are being disposed of by the common order for the sake of convenience.

The common issue arising from the cross appeals relates to the disallowance of Rs. 59,50,64,076 under section 40(a)(ii) of Income Tax Act, 1961 (hereinafter referred to as 'Act'). Briefly stated, the facts are there: The assessee is distributor of Software products. During the year under consideration, the assessee purchased software from various non-resident parties and paid total consideration of Rs. 59,50,64,076, which was claimed as revenue expenditure. The assessing officer, for the reasons given in the assessment order, treated such sum as payment on account of 'Royalty' under section 9(1)(vi) of the Act. Since no tax was deducted at source by the assessee at the time of making payments, the assessing officer disallowed the same as revenue expenditure under section 40(a)(i) of the Act. The Commissioner (Appeals), for the reasons given in his order, confirmed the finding of assessing officer that such payments fell within the ambit of section 9(1)(vi) of the Act and consequently, the assessee was under the

obligation to deduct the tax at source under section 195. Hence, provisions of section 40(a)(i) of the Act were attracted. However, he accepted the alternate plea of assessee that since the biggest supplier of software, namely, 'Microsoft Regional Sales Corp., Singapore had paid the tax on the amount received by the assessee, no disallowance is justified to that extent. This plea was accepted after following various judgments of various High Courts. Accordingly, he deleted the disallowance to the extent of Rs. 5,460.80 lakhs after verifying the fact that tax due was paid by Singapore party on 22-3-2004. Aggrieved by the same, the assessee as well as the revenue are in appeal before the Tribunal.

The assessee is aggrieved by the finding of the Commissioner (Appeals) that payment on account of purchase of software amounted to 'Royalty' within the meaning of section 9(1)(vi) of the Act while the revenue is in appeal against the finding of the Commissioner (Appeals) that no disallowance under section 40(a)(i) could be made if it is found that due tax has been paid by the non-resident supplier. The learned Counsel for the assessee has submitted that the issue is now covered by the decision of the Tribunal in assessee's own case wherein it has been held that such payment could not be considered as payment on account of royalty within the ambit of section 9(1)(vi) of the Act and consequently, assessee was not legally required to deduct tax at source under section 195. On the other hand, the learned Departmental Representative has relied on the reasonings given by the Commissioner (Appeals) as well as assessing officer in their orders, We have considered the submissions of the rival parties. The issue before us has already been concluded by the decision of the Tribunal dated 28-4-2005 in assessee's own case wherein the Tribunal, following its decision in the case of Samsung Electronics Ltd. 93 TTJ 658 (Bang.) has held that payment made by assessee for purchase of software did not amount of 'Royalty' within the ambit of section 9(1)(vi) of the Act and therefore, assessee was not liable to deduct tax at source under section 195. Following the said decision, it is further held that, as a necessary corollary, the provisions of section 40(a)(i) could not be applied to the case of assessee. The finding of Commissioner (Appeals) that payment towards purchase of software amounted to 'Royalty' within the meaning of section 9(1)(vi) of the Act is hereby vacated.

We are also unable to uphold the other finding of Commissioner (Appeals) that disallowance under section 40(a)(i) could not be made and since the non-resident Co. paid the tax on the amount received by them from assessee. The reason is obvious as the deduction under section 40(a)(i) is allowable only in the year in which tax has been paid. The main provision disentitles the assessee from claiming deduction if the tax deducted has not been paid. Further, the proviso in clear terms provides that where tax has been paid in any subsequent year then deduction shall be allowed in the year in which such tax has been paid. In the present case, it has been noted by the Commissioner (Appeals) that the non-resident had paid the tax on 22-3-2004, consequently, deduction could be claimed only in the assessment year 2004-05 and not in the year under consideration. The Commissioner (Appeals), therefore, was incorrect in holding that no disallowance could have been made under section 40(a)(i) of the Act as the tax was ultimately paid by non-resident. Accordingly, we also vacate this finding of the Commissioner (Appeals).

In view of the above discussion, we set aside the order of Commissioner (Appeals) and deleted the entire disallowance under section 40(a)(i) made by assessing officer and sustained by Commissioner (Appeals).

The next issue arising from the appeal of assessee relates to the disallowance of Rs. 6,55,88,590 on account of service charges paid to Sonata Software Ltd. (SSL). Brief facts giving rise to this appeal are these: The assessee is 100 per cent subsidiary of SSL. It came into existence in the year under consideration with the object to carry out one of the activities of SSL which was not eligible for exemption under section 10A. Prior to the year under consideration, SSL was carrying out two independent activities i.e., (i) activity eligible for exemption under section 10A and (ii) the activity not eligible for exemption under section 10A. Separate accounts were maintained by SSL for these activities. Direct expenses relating to these activities were accounted for in the separate accounts respectively. However, service charges were common and later on allocated to these activities on the basis of turnover. The assessee, after its incorporation, took over the activity of SSL, which was not eligible for exemption under section 10A on 1-7-2000. However, an agreement was entered into between assessee and SSL

to the effect that SSL would continue to incur expenses in the nature of service charges on behalf of assessee as before and the same would be reimbursed by the assessee. The assessee paid the sum of Rs. 6,55,80,590 as service charges for the year under consideration and claimed the same as business expenditure.

The assessing officer disallowed the entire expenditure by observing as under: "(i) The following tabulation gives details of the sales, expenditures claimed of the nature 'Legal & Professional expenses' and of the nature 'Recruitment & Training' in the separate Profit & Loss Accounts prepared for the non- 10A activity of SSL in the assessment years 1998-99, 1999-2000 and 2000-01 and in the case of the assessee company for the assessment years 2001-02 and 2002-03.

From the above, it is observed that the expenditure in SSL under the heads 'Legal and professional' and 'Recruitment and training' for the assessment years 1998-99 to 2000-01 increased in proportion to the turnover from Rs. 18.25 lakhs to Rs. 49.09 lakhs (Rs. 39.5 lakhs + Rs. 9.5 lakhs). However, in comparison to this, the expenditure on account of 'Service charges' (which encompasses the expenditures claimed under the said two heads) in the assessee company for assessment years 2001-02 and 2002-03 has been claimed at an abnormally high amount of Rs. 655.88 lakhs and Rs. 910.27 lakhs respectively, disproportionate to the turnover of the assessee.

(ii) It has been stated in the said agreement of SSL with the assessee company that all out of pocket expenses including travel, conveyance etc. are to be billed separately by SSL and shall be reimbursed by the assessee. However rather than separately billing for these out of pocket expenses, SSL is raising periodic lump sum credit notes by apportioning the expenditure incurred by SSL on account of insurance, salaries and allowances, directors remuneration, electricity and water charges, printing and stationery, professional charges, repairs and maintenance, rent for offices and also depreciation. The assessee was categorically asked to furnish supporting evidences to show that the said services stated at (a) to (d), above were rendered by SSL.

However, the assessee has not furnished the same till the finalisation of the assessment. The only evidences submitted are the debit/credit notes raised on the

assessee by SSL according to which the expenses incurred in SSL have been apportioned to the assessee on the basis of turnover of the assessee and SSL. Payment of service charges from SITL to SSL is mere diversion of income without services rendered by SSL.

Mens rea of this claim is to reduce taxable profit and claim more 10A profit in SSL.

(iii) The receipts on account of Service Charges in the hands of SSL have not been credited separately as the income of its non-10A activity. However, these receipts have been reduced from the expenditure claimed of 10A activity of SSL. The net implication of this is that the profits of the 10A activity of SSL have increased and on which no tax has been paid. Whereas in fact, these receipts are clearly pertaining to the non 10A activity of SSL and therefore such receipts should have been offered for tax.

(iv) The assessee has contended that the said agreement has been executed in the best interest of the business between two independent corporate entities. It has also been contended that the same has been incurred out of commercial expediency. It has further been submitted that it is the prerogative of the businessman as to how to run its business and the department should not prescribe the quantum of expenditure etc. These contentions of the assessee would have been acceptable if this agreement was entered into between two independent entities not under the common management and control. In the instant case, the assessee is a 100 per cent subsidiary of SSL. The implication of this agreement is that the taxable profits of the assessee have been reduced and at the same time increasing the non-taxable profits of its holding company SSL.

(v) On perusal of the Balance Sheet of the assessee company, it is observed that out of the total service charges of Rs. 655.88 lakhs payable to SSL for the relevant year, an amount of Rs. 522.57 lakhs is outstanding as on 31-3-2001. This further indicates that the basic purpose of this agreement is to reduce the tax liability in the hands of the assessee and increase the non-taxable profits of SSL." In para 4.4 of his order, the assessing officer also observed that entire exercise was a colourable device to reduce its tax liability and to increase non-taxable profits of

SSL.

The matter was carried in appeal before the Commissioner (Appeals) before whom it was submitted that : "Before me in the appeal proceedings, it was explained on behalf of the assessee that assessing officer has misled himself in presuming that the agreement for services covers only the legal and professional charges and recruitment and training expenses. It was explained that the area of services covered under the agreement is very broad and that the expenditure has been claimed on the basis of actual expenditure incurred on the basis of debit notes received from SSL and that if the expenditure in question was not incurred the assessee would not have been able to carry on its business. It was further submitted that the debit notes issued by SSL and the details given to the assessing officer in support of the expenditure included in the debit notes show that not only legal and other specified services were the subject in the agreement but also other services which are not specifically stated in the agreement were also included." The Commissioner (Appeals) examined the details of the expenditure which had been allocated on the basis of respective turnover which was given along with debit notes. It has been made clear that such details were also furnished before assessing officer. (See pages 23-24 of the order). it was noted by Commissioner (Appeals) that entire expenditure was incurred commonly for SSL and assessee and was allocated on the basis of turnover. According to him, business activity of SSL was much more expenditure oriented than business activity of assessee. Hence, in his opinion, the expenditure on support services to the assessee in the ratio of turnover was patently wrong. After going through the agreement, it was also held that SSL was required to advise the assessee in the matters of finance, accounts, taxation, legal, administration, HRD etc., and proper maintenance of record, compliance under various laws and training of employees. He also noted that assessee itself had incurred operational expenses of Rs. 835.76 lakhs which shows that assessee itself maintaining a large force of its employees. Such expenses amounted to 8.31 per cent of total turnover which itself was very high. Proceeding further, he examined the nature of expenses of SSL, which had been allocated on the basis of turnover.

He found that such expenses were incurred on account of various heads totalling 44. According to him, such services had nothing to do with services mentioned in the agreement. In his view, only a portion of salaries and other allowances of employees working in finance, accounts taxation, legal administration, HRD, education and research and training department could be allocated. He then estimated the sum of Rs. 50 lakhs towards the services of SSL rendered from assessee and held the same to be allowable. Rest of the expenditure was held to be disallowable. Aggrieved by the same, the assessee is in appeal before the Tribunal.

We have heard both the parties in the light of the materials placed before us. We find that the issue regarding the allocation of expenses in respect of service charges arose in the case of SSL. In that case, the assessing officer was of the view that allocation of expenses of Non- 10A unit (not eligible for exemption) was excessive as exempted unit was much more expenditure oriented. The matter ultimately reached the Tribunal which accepted the case of assessee that allocation of support services expenses on the basis of turnover was justified. The Tribunal, vide para 34 of its order dated 17-3-2003 in ITA No.495/496/M/02, held as under: "We have considered the submissions and we have perused the various records placed in the paper book. In the paper book at pages 27 to 34, the assessee has placed each and every head of expenditure and this expenditure has been bifurcated under the three heads - STP unit entitled to deduction under section 10A, non-STP not entitled to deduction under section 10A and support services. Further, it is found that the basis of allocation amongst the three heads is actual expenses, number of employees and ratio of fixed assets, floor area and turnover ratio. Thus, on the basis of above five criteria, expenditure has been allocated to the three heads. Further, it is noticed that the total expenditure allocated under third head i.e., support services, has been again allocated under two heads-(I) STP units entitled to deduction under section 10A and non-STP which is not entitled for deduction under section 10A on the basis of turnover ratio. In our considered opinion the allocation of expenditure contained in the paper book at pages 27 to 31 appears to be appropriate. As per details contained in pages 27 to 31, it can be seen that the appellant company has only allocated expenses of Support Service Division between 10A and non-10A activities in the

ratio of turnover has been called for by the assessing officer by this letter dated 20-1-2000 appearing at page 35 of the paper book. Further, direct expenses relating to 10A and non- 10A activity has been directly charged against the profits of these activities and do not call for any interference." The above observations of the Tribunal resolve the controversy before us. Admittedly, prior to incorporation of assessee company, SSL was carrying on two units independently ie., unit exempted under section 10A and the unit not exempted. Direct expenses incurred were separately booked to respective units. Only the support services expenses were allocated on the basis of turnover. Such allocation has been found to be proper and reasonable by the Tribunal. There is no dispute that non-exempted unit was taken over by the assessee company and support services were continued to be rendered by SSL. From the inception, the stand of the assessee has been that such expenses were allocated on the basis of turnover as is apparent from para 4.3.3(ii) of the assessment order, wherein it has been mentioned that expenses were allocated in debit notes as the basis of turnover. Even the Commissioner (Appeals) has also admitted this factual position at page 23 of his order where he mentioned "The details of the expenditure which has been allocated on the basis of respective turnover is given along with debit notes, copies of which were filed before me, as also before the assessing officer". Faced with the same, the learned departmental Representative had nothing to add except to rely on the order of assessing officer.

The learned departmental Representative submitted that allocation of expenses requires verification and therefore, the matter may be referred to assessing officer for necessary verification. We are unable to accept this request since there is no dispute to the factual position that allocation of service expenses was made on the basis of turnover. No useful purpose would be served in restoring the issue.

Accordingly, following the finding of the Tribunal in the case SSL, we set aside the order of Commissioner (Appeals) on this issue and delete the disallowance sustained by him.

In the result, the appeal of the assessee is allowed while the appeal of revenue is dismissed.

