

Millennium Infocom Technologies Vs. Assistant Commissioner of Income

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Court : Income Tax Appellate Tribunal ITAT Delhi

Decided On : Jan-31-2008

Reported in : (2008)117TTJ(Delhi)456

Judge : N Karhail, K Ranjan

Appellant : Millennium Infocom Technologies

Respondent : Assistant Commissioner of Income

Judgement :

1. This appeal by the assessee for asst. yr. 2001-02 arises out of order of CIT(A)-IX, New Delhi.

2. The first issue consideration relates to sustaining of disallowance of Rs. 3,26,386 under Section 40(a)(i) of the Act. The facts of the case stated in brief are that during the year under consideration, the assessee incurred total expenditure of Rs. 5,01,183 for domain registration. After capitalizing an amount of Rs. 1,74,797 for website launched in the year, an amount of Rs. 3,26,386 was claimed as revenue expenditure. The assessee paid these amounts through credit cards. It was explained by the assessee that since the payments were made to non-resident foreign companies and the provisions of Section 195 were not applicable to foreign/non-resident companies, the assessee was not statutorily liable to deduct tax at source. The AO relying on the provisions of Section 195 held that the TDS provisions were applicable both to non-companies and foreign companies. AO followed the decision of Tribunal Hyderabad Bench in the case of Cheminor

Drugs Ltd. v. ITO wherein it was held that wherever remittances abroad were made, it was the duty of the assessee to apply for nil deduction or deduction at lower rate under Section 195(2) and if the payer remitted the same without TDS or without certificate there was a liability on the payer to pay tax. Reliance was also placed on the decision in the case of Fertilisers & Chemicals Travancore Ltd. v. CIT (2002) 174 CTR (Ker) 257 : (2002) 255 ITR 449 (Ker) wherein the Indian company was held to be liable to deduct tax at source under Section 195(1) on payments made to foreign collaborator. He, accordingly, disallowed the amount of Rs. 3,26,386 under Section 40(a)(1) of the Act.

3. On appeal it was explained that the assessee paid Rs. 59,037 to Bulk Register LL.C, Maryland and Rs. 6,662 to Network Solution, Inc.

Virginia on internet through credit card for registering of the domain name for a particular period. Further a sum of Rs. 1,53,343 was paid to Rackspace Com. Texas and Rs. 1,07,643 to Hostme Bethlehem on account of server charges for launching of different websites through internet.

These companies were located outside India and did not have any office in India. The assessee company did not have copies of agreement with Bulk Register, Network Solution Inc., Hostme Bethlehem. However, copy of agreement with Rackspace. Com. was made available. In view of these facts, it was pleaded that since the websites could be viewed from.

India, the amount paid on account of server charges for the purpose of hosting websites did not amount to rendering of any services by these companies in India. No tax was deducted at source as no income accrued in India since the services were rendered from abroad and no income was chargeable to tax within the meaning of Section 195 of the Act.

Reliance was also placed on the decision of Hon'ble Supreme Court in the case of Transmission Corporation of A.P. Ltd. v. CIT wherein it was held that the obligation to deduct tax at source would be required to be fulfilled only in relation to income portion of the sum embedded in the gross amount and therefore it would be wrong to expect the deduction of tax' at source on the gross sum regardless of income

element therein. It was also pleaded that since payments were made through credit cards, no remittance was made from India and accordingly provisions of Section 195 of the Act were inapplicable. The decision of Tribunal Hyderabad Bench in the case of Cheminor Drugs Ltd. (supra) was not applicable to the facts of the case as in that case remittance was made from India and services were rendered in India and accordingly the amount was chargeable to tax in India.

4. On appeal learned CIT(A) after considering the submissions observed that the domain name registration provided customer support, account management tool, domain security features and a service level agreement with domain name register. The hiring of server and providing of web-hosting services were in the nature of technical services. Thus the payments made by the assessee were for technical services in terms of Section 9(1)(vii) of the Act, which represented income, deemed to accrue or arise in India of the recipient. She also observed that the payments made to the non-residents also fell within the ambit of Section 9(1)(vi) of the Act as these were in the nature of royalties as defined in Explan. 2 to Section 9(1)(vi) of the Act. Consideration for domain registration amounted for the use of property similar to trademark referred to in Clause (iii) of the said Explan. 2 and hiring of server implied the use of processes of the server and hence also fell within Clause (iii) of the said Explan. 2.

4.1 She further observed that the Authority for Advance Rulings held that if payment is made for services which are utilized in a business or profession carried on by the payer in India or for the purpose of making any income from a source in India, they will be deemed to accrue or arise in India. The Authority affirmed that if the services are utilized in a business in India then irrespective of the place where the services are rendered the amounts should be deemed to accrue or arise in India. Since the websites were accessible from India, the usage was in India and hence the payments represented income arising in India of the recipient.

4.2 As regards for non-deduction of tax at source she placed reliance on the decision of Hon'ble Supreme Court in the case of Transmission Corporation of A.P. Ltd. (supra). She held that in absence of determination by the AO that a particular sum was not chargeable to tax in the case of the recipient, tax must be

deducted at source. She upheld the stand taken by the AO relying on the decision of Tribunal, Hyderabad Bench in the case of Cheminor Drugs Ltd. (supra). Since the assessee had not obtained the concurrence of the AO under Sub-section (2) of Section 195 of the Act, the amount was not deductible under Section 40(a)(1) of the Act.

5. Before us the learned Authorised Representative of the assessee Sh.

Sharat Dev Kapila submitted that the facts of the case are not in dispute. The assessee is engaged in the business of setting up of websites for the purposes of E. Commerce. For hosting of the websites, the assessee required servers, which were not available in India at the relevant time. For this purpose the assessee took servers on lease and paid rentals to non-resident entities through credit card. Learned Authorised Representative of the assessee referring to OECD (Organization of Economic Co-operation and Development) Model Tax Convention submitted that none of the parties to whom lease rentals have been paid, had PE in India. Therefore the lease rentals paid to them do not relate to business operations carried on by those parties.

The assessee had hosted websites on the servers which could be visited by the interested persons to mine the electronic data. The assessee had not made payment on account of technical services provided by non-resident resulting in accrual or arising of income in India in terms of provisions of Section 9(1)(vii) of the IT Act, 1961. However rentals paid could be treated as royalties for the use of servers owned by the non-resident persons for the purpose of hosting the websites. He further submitted that Clause (iva) of Explan. 2 to Section 9(1)(vi) was inserted by the Finance Act, 2001 w.e.f. 1st April, 2002. Therefore the amount paid as rentals cannot be treated as royalty chargeable to tax in India for asst. yr. 2001-02 under consideration. Consequently provisions of Section 195(1) are not applicable. It has further been submitted that once an assessee denies the application of Section 195(1), the provision of Section 195(2) will not be applicable requiring him to apply to AO for permission for non-deduction or lower deduction of tax at source. The AO had relied on the decision of Hon'ble Supreme Court in the case of Transmission Corporation of A.P.Ltd. v. CIT (supra) which in fact supports

the case of the assessee.

The AO has also placed reliance on the decision of Tribunal Hyderabad Bench in the case of Cheminor Drugs Ltd. v. ITO (supra) wherein it has been held that wherever there is a remittance abroad, it was the duty of the assessee to apply for nil deduction or deduction at lower rate under Section 195(2) of the Act. The provisions of Section 195(2) are not penal provisions. These are machinery provisions. It has been further submitted that Tribunal Hyderabad Bench had not considered the decision of Hon'ble Andhra Pradesh High Court in the case CIT v. Superintending Engineer, Upper Sileru which was available at the relevant time. Revenue had accepted the part of the decision of Hon'ble Andhra Pradesh High Court holding that only portion of the amount, which represented income or profit was liable for deduction of tax at source. As at that point of time the decision of Hon'ble Supreme Court in the case of Transmission Corporation of A.P. Ltd. (supra) was not available, the decision of Tribunal Hyderabad Bench in the case of Cheminor Drugs Ltd. (supra) without considering the decision of jurisdictional High Court is per incurium. Since the amount paid as lease rental is not in nature of income, the decision of Tribunal Hyderabad Bench in the case of Cheminor Drugs Ltd. (supra) is not applicable to the facts of the case. The latter decision of Tribunal Delhi Bench in the case of Lufthansa Cargo India (P) Ltd. v. Dy. CIT (2005) 92 TTJ (Del) 837 : (2005) 275 ITR 20 (Del)(AT) should have been taken into account.

5.1 Further, learned CIT(A) in para 10 of his order had treated the hiring of servers for the purpose of web hosting services in the nature of technical services. This view of learned CIT(A) is not correct as there was no supply of technology to the assessee. The assessee had taken space in the servers on rent which cannot be treated as transfer of technology or providing of technical services by the non-resident parties to the assessee. He placed reliance on the decision of Hon'ble Madras High Court in the case of Skycell Communications Ltd. v. Dy. CIT (2001) 170 CTR (Mad) 238 where in it has been held that payments for providing cellular mobile telephone services were not capable of being regarded as technical services and could not become so when used by firms and companies. He also placed reliance on the decision of Tribunal Delhi Bench in the case of Dy. CIT v.

Panamsat International Inc.

transponder capacity could not be taxed as royalty. Placing reliance on the decision of Authority for Advance Rulings in the case of Cargo Community Network Pte Ltd. In re (2007) 208 CTR (AAR) 184 : (2007) 289 ITR 355 (AAR) it has been submitted that under agreement for avoidance of double taxation between India and USA, the payment of royalty is assessable to tax in India. However for asst. yr. 2001-02, Clause (iva) of Expln. 2 was not in the statute and therefore the lease rental paid by the assessee will be assessable as business income in USA. For this proposition he placed reliance on the memorandum explaining the provisions of the Finance Bill, 2001 reported in (2001) 248 ITR (St) 200. Learned Authorised Representative of the assessee further submitted that the learned CIT(A) had not made out any case against the assessee. It has further been submitted that Article 26(3) of the DTAA between India and USA protects the assessee. He placed reliance on the decision of Tribunal Delhi Bench in the case of Herbalife International India (P) Ltd. v. Asstt. CIT Representative of the assessee further submitted that Article 24(4) of OECD Model Convention provides that 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. On the basis of above arguments it has been pleaded that provisions of Section 195 are not attracted in the case of the assessee.

6. On the other hand learned Departmental Representative submitted that provisions of Section 195(1) statutorily cast responsibility on the assessee to deduct tax at source at the time of payment or credit into the account of the payee. Section 195 provides for deduction of tax at source subject to regular assessment to be made later on. The determination of nature and income is to be done at time of regular assessment. Placing reliance on the decision of Hon'ble Supreme Court in the case of Transmission Corporation of A.P. Ltd. (supra), he submitted that by deduction of tax at source at the time of payment made to the non-resident, the rights of the parties are not, in any manner, adversely affected. The rights of recipients are fully safeguarded under Sections 195(2), 195(3) and 197 of the Act.

The only thing which is required to be done is to file an application for determination by the AO that such sum would not be chargeable to tax in the case of the recipients, or for determination of appropriate portion such sum so chargeable, or for grant of a certificate authorizing the recipients to receive the amount without deduction of tax, or deduction of income-tax at any lower rate. On such determination, tax at the appropriate rate could be deducted at source. If such an application is not filed, income-tax on gross sum is to be deducted at source and it is statutory obligation of the person responsible for paying such sum to non-resident irrespective of fact that the whole amount may not be the income or profits of the recipients. It is statutory obligation of the assessee to deduct tax at source. He placed reliance on the decision of Tribunal in the case of HNS India Vsat Inc. v. Dy. Director of IT . He further submitted that learned CIT(A) was not called upon to decide the nature of income i.e. the income was in the nature of fees for technical services or royalty. To determine the nature of the payments was not an issue before learned CIT(A) nor is an issue before Tribunal. The decision of Hon'ble Madras High Court in the case of Skycell Communication Ltd. (supra) relied upon by the assessee is not applicable to the facts of the case as in that case the issue related the end-users and not a case of relating to technical services.

He further submitted that the facts of the case of Panamsat International Systems (supra) are also not applicable to the facts of the case of the assessee. In this case the assessee was a service provider whereas in the instant case, the assessee had borrowed the services of non-residents. According to learned Authorised Representative of the assessee, the payments are in nature of royalties and not fees for technical services and hence liable to be assessed under the Act. He further submitted that in the case of Herbalife International India (P) Ltd. (supra), the payments were made by the subsidiary company, to parent company whereas in the case of assessee the payments have been by a resident to foreign companies. Therefore the provisions of DTAA are not applicable to the facts of the case. The provisions of the DTAA are applicable when income of non-resident is taxable either in USA or in India. Article 26(3) can be invoked in such situation and hence not applicable. Learned Departmental Representative also placed reliance on the decision of Authority for Advance Rulings in the case of

Timken India Ltd., In re and Headstart Business Solution (P) Ltd. In re .

7. In rejoinder the learned Authorised Representative of the assessee submitted that the provisions of Section 195 are substantive in nature and the AO is duty-bound to exercise his powers judiciously for finding out the defaults committed by the assessees. If there was no default committed by an assessee the order passed under Sections 201(1) and 40(a)(i) will be bad in law. The expression "sum chargeable to tax" has to be read contextually. He placed reliance on the decision of Hon'ble Supreme Court in the case CIT v. Sun Engineering Works (P) Ltd. . As per the verdict of Hon'ble Andhra Pradesh High Court, the nature of income has to be determined under Section 195 of the Act in order to determine the tax payable at the time of the remittance to the non-resident. The second part of this decision relating to determination of nature of the income has been accepted by the Department. Therefore, it is incorrect on the part of the Department to raise the issue now that the nature of income is not required to be determined under Section 195 of the Act at the time of the remittance of the amount to the non-resident. He also submitted that the decisions of Authority for Advance Rulings in the case of Timken India Ltd. (supra) and Headstart Business Solution (P) Ltd. (supra) are not binding on Tribunal. The decision in the case of Timken India Ltd. (supra) relates to fee for technical services whereas the decision in the case of Headstart Business Solution (P) Ltd. (supra) relates to gross receipts to be charged to tax. In HNS India (supra) Tribunal has determined the nature of the income. He further submitted that the decision of Tribunal Delhi Bench in the case of Lufthansa Cargo India (P) Ltd. (supra) has not been distinguished. The decision of Hon'ble Madras High Court in the case of Skycell Communications Ltd. (supra) will be applicable to the facts of case. Finally it has been submitted that after issue of Circular No. 759 on 18th Nov. 1997 [(1997) 143 CTR (St) 290], the rigours of Section 195 have been reduced and RBI is the authority to take action in case of any violation.

8. We have heard both the parties and perused the material available on record. The facts of the case are not in dispute. The assessee had paid Rs. 3,26,386 to four non-resident companies for launching of different websites on their servers located in USA. No tax was deducted while making the remittance on the ground

that the amount was not chargeable to tax in India. The assessee claimed deduction in respect of the said amount as revenue expenditure. The AO disallowed the amount under Section 40(a)(i) on the ground that the assessee did not deduct any tax at source at the time of remittance to non-resident. Under Section 40(a)(i) relevant to asst. yr. 2001-02, in the case of any assessee, any interest (not being interest on a loan issued for public subscription before the 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 has not been paid or deducted under Chapter XVII-B shall not be deducted in computing the income chargeable under the head "Profits and gains of business or profession". Proviso to sub-clause further says that where in respect of such sum tax has been paid or deducted under Chapter XVII-B in any subsequent year, such sum shall be allowed as deduction in computing the income of the previous year in which such tax has been paid or deducted. Sub-clause (ia) which contains identical provisions in respect of payments made to a resident has been inserted by the Finance (No. 2) Act, 2004, w.e.f.

1st April, 2005. In this sub-clause words "rent, royalty" have been inserted w.e.f. 1st April, 2006. Provisions of Sub-clause (i) deal with the payments made outside India or to a non-resident whereas Sub-clause (ia) deals with the payments made to residents. Thus w.e.f. 1st April, 2005 payments made to a resident on account of interest or fee for technical services and royalty w.e.f. 1st April, 2006 will also not be allowed as deduction unless tax at source has been deducted. From the language employed in Sub-clause (i) it is clear that the payments made outside India or to a non-resident on account of any interest, royalty, fee for technical services or other sum should be chargeable to tax in India. In the case of assessee, the payments have been made to non-residents on account of rentals for hosting the websites on their servers located in USA. Thus we have to examine nature of the payments made whether they are in nature of interest or royalty or fee for technical services or other sum chargeable to tax in India. Admittedly payments made are not in nature of interest as these are not relatable to any loan/trade advances.

8.1 The expression "Fees for technical services" is defined in Expln. 2 to Section 9(1)(vii) and reads thus: For the purposes of this clause, 'fee for technical services' means any consideration (including any lump sum consideration) for the rendering of any managerial, technical or consultancy services (including the provision of services of technical or other personnel) but does not include consideration for any construction, assembly, mining or like project undertaken by the recipient or consideration which would be income of the recipient chargeable under the head 'Salaries'.

This definition shows that consideration paid for rendering of any managerial, technical or consultancy services, as also the consideration paid for the provision of services of technical or other personnel, would be regarded as fees paid for "technical services". The definition excludes from its ambit the consideration paid for construction, assembly, or mining or like project undertaken by the recipient, as also consideration which would constitute income of the recipient chargeable under the head "Salaries".

8.2 Hon'ble Madras High Court in the case of Skycell Communication Ltd. and Anr. (supra) had an occasion to examine the scope of term "technical services". It has been held as under: Thus while stating that 'technical service' would include managerial and consultancy service, the legislature has not set out with precision as to what would constitute 'technical' service to render it 'technical service'. The meaning of the word 'technical' as given in the New Oxford Dictionary is adjective 1. of or relating to a particular subject, art, or craft or its techniques; technical terms (especially of a book or article) requiring special knowledge to be understood : a technical report, 2. of involving, or concerned with applied an industrial sciences : an important technical achievement, 3. resulting from mechanical failure : a technical fault, 4.

according to a strict application or interpretation of the law or the rules : the arrest was a technical violation of the treaty.

Having regard to the fact that the term is required to be understood in the context in which it is used, 'fee for technical services' could only be meant to cover such things technical as are capable of being provided by way of service for a fee. The

popular meaning associated with technical' is 'involving or concerning applied and industrial science'.

5. In the modern day world, almost every facet of one's life is linked to science and technology inasmuch as numerous things used or relied upon in every day life is the result of scientific and technological development. Every instrument or gadget that is used to make life easier is the result of scientific invention or development and involves the use of technology. On the score, every provider of every instrument or facility used by a person cannot be regarded as providing technical service.

When a person hires a taxi from one place to another, he uses a product of science and technology, viz., an automobile. It cannot on that ground be said that the taxi driver who controls the vehicle and monitors its movement is rendering a technical service to the person who uses the automobile. Similarly when person travels by a train or in an airplane it cannot be said that the railways or airlines is rendering a technical services to the passenger and, therefore, the passenger is under an obligation to deduct tax at source on payment made to the railways or the airline for having used it for traveling from one destination to another. When a person travels by bus, it cannot be said that the undertaking which owns the bus services is rendering technical service to the passenger and, therefore, the passenger must deduct tax at source on the payment made to the bus service provider, for having used the bus.

The electricity to an consumer cannot, on the ground that generators are used to generate electricity, transmission lines to carry the power, transformers to regulates the follow of current, meters to measures that consumption be regarded as amounting to provision of technical services to the consumer resulting in the consumer having to deduct that at source on the payment made for power consumed and remit the same to the Revenue....

Installation and operation of sophisticated equipments with a view to earn income by allowing customers to avail of the benefits of the user of such equipments do not result in the provision Lo technical service to the customer for a fee.

On applying the above stated reasoning to the facts of case before us it can be safely concluded that providing of space on the servers by the non-residents for the purpose of hosting of the website will not result in the provision to technical service to the assessee for a fee.

Therefore the payments were not made for fees for technical services liable to be taxed in India.

8.3 Now we have to examine whether payment of rentals for hosting of websites on the servers amounts to royalty. Explanation to Section 40(a)(i) states that for the purposes of Sub-clause (i) "royalty" shall have the same meaning as in Expln. 2 to Clause (vi) of Sub-section (1) of Section 9. Explanation 2 to Clause (vi) of Section 9(1) for and up to asst. yr. 2001-02 read as under: Explanation 2 For the purposes of this clause, 'royalty' means consideration (including any lump sum consideration but excluding any consideration which would be the income of the recipient chargeable under the head 'Capital gains') for- (i) the transfer of all or any rights (including the granting of a licence) in respect of a patent, invention, model, design, secret formula or process or trademark or similar property; (ii) the imparting of any information concerning the working of or the use of, a patent, invention, model, design, secret formula or process or trademark or similar property; (iii) the use of any patent, invention, model, design, secret formula or process or trademark or similar property; (iv) the imparting of any information concerning technical, industrial, commercial or scientific knowledge, experience or skill; (v) the transfer of all or any rights (including the granting of a licence) in respect of any copyright, literary, artistic or scientific work including films or video tapes for use in connection with the television or tapes for use in connection with radio broadcasting, but not including consideration for the sale, distribution or exhibition of cinematographic films; or (vi) the rendering of any services in connection with the activities referred to in Sub-clause (i) to (v).

From above-mentioned definition of "royalty" one can find that none of the clauses of the Explanation takes into its ambit the consideration paid for renting of space for hosting of websites on servers. However, Clause (iva) to Expln. 2 was inserted by the Finance Act, 2001, w.e.f. 1st April, 2002 which reads as under: (iva) the use

or right to use any industrial, commercial or scientific equipment but not including the amounts referred to in Section 44BB.8.4 Thus w.e.f. 1st April, 2002, the consideration for use or right to use industrial, commercial or a scientific equipment is royalty. As per OECD (Organization of Economic Co-operation and Development) Model Tax Convention server on which the website is stored and through which it is accessible is a piece of equipment having a physical location. The OECD Model Tax Convention is applicable between two developed countries whereas U.N. Model Tax Convention is applicable between developed and developing countries. However the wording of OECD Model Tax Convention and U.N. Model Tax Convention is identical. Thus the nature of the rent paid for hosting of the website on the servers being commercial and scientific equipment is to be treated as royalty.

8.5 The legislative intention for insertion of Clause (iva) to Expln. 2 to Section 9(1)(vi) can be traced from the Memorandum explaining the provisions of the Finance Bill, 2001 reported in (2001) 248 ITR (St) 200 and is reproduced as below: Under the existing provisions contained in Clause (vi) of Sub-section (1) of Section 9, income by way of royalty payable is deemed to accrue or arise in India subject to certain conditions.

The term 'royalty' has been defined in Expln. 2 to this clause.

The definition of the term 'royalty' as used in the DTAAs entered into by India includes inter alia payments 'for the use of, or the right to use, industrial, commercial or scientific equipment'.

Presently, these payments are not included in the definition of royalty in the aforesaid Explanation. The result is that income from the leasing of industrial, commercial or scientific equipment becomes taxable in the source country as business income only.

Consequently, there is no withholding tax on such payments as the taxpayer takes shelter under the definition of the term 'royalty' as provided in the IT Act since the same is more beneficial to him.

It is therefore, proposed to amend Section 9 so as to widen the scope of the term 'royalty' as provided in Expln. 2 of Clause (vi) of Sub-section (1) of Section 9 so as to include in its ambit consideration for the use of or right to use. industrial, commercial or scientific equipment.

The proposed amendment will take effect from 1st April, 2002 and will accordingly, apply in relation to asst. yr. 2002-03 and subsequent assessment years.

Form plain reading of the memorandum explaining the provisions of the Finance Bill, 2001, it is clear that prior to the amendment, the consideration for the use of, or the right to use, industrial, commercial or scientific equipment was not included in the definition of "royalty" in Expln. 2 and consequently the income from the leasing of industrial, commercial or scientific equipment became taxable in the source country as business income from asst. yr. 2002-03 and onwards., 8.6 As per para 1 of Article 12 of DTAA between India and USA, dt. 20th Dec. 1990. royalties and fees for included services arising in a Contracting State and paid to a resident of other Contracting State may be taxed in that other State. However, as per para 2 of Article 12 such royalties and fees for included services may also be taxed in the Contracting State in which they arise and according to the laws of that State, but if the beneficial owner of the of the royalties or fees for included services is a resident of other Contracting State, the tax so charged shall not exceed the specified percentage mentioned in this article. We also find that para 3(b) of Article 12 takes into its ambit the payments of any kind received as consideration for the use of, or the right to use any industrial, commercial or scientific equipment other than equipments relating to shipping and air transport described in para 2(c) or 3 of Article 8. Though the DTAA between India and USA provides for taxing of royalties for the use of, or the right to use any industrial, commercial or scientific equipment in the Contracting State in which they arise and according to the laws of that State but the same could not be taxed in India up to asst. yr. 2001-02 as Clause (iva) of Expln. 2 to Section 9(1)(vi) was inserted w.e.f. 1st April, 2002.

8.7 CBDT in their Circular No. 759 dt. 18th Nov., 1997 in F. No.500/152/96-FTD dispensed with the requirement of no objection certificate to be obtained from the AO at the time of remittance outside India. Circular No. 759 is reproduced as

under: Sub : Remittance to a non-resident-- Deduction of tax at source-- Submission of no objection certificate--Dispensing with--Regarding 1. Section 195 of the IT Act, 1961 provides that any person responsible for paying to a non resident any sum chargeable under the Act shall, at the time of credit of such income to the account of the payee, or at the time of payment thereof in cash or by cheque or draft or any other mode, whichever is earlier, deduct income tax thereon at the rates in force.

2. The RBI have provided in their office manual that no remittance shall be allowed unless a no objection certificate has been obtained from the IT Department. It has since been decided that henceforth remittances may be allowed by the RBI without insisting upon a no objection certificate from the IT Department and on the person making the remittance furnishing an undertaking (in duplicate) addressed to the AO accompanied by a certificate from an accountant (other than an employee) as defined in the Explanation below Section 288 of the IT Act, 1961 in the form annexed to this circular. The person making the remittance shall submit the undertaking along with the said certificate of the accountant to the RBI, who in turn shall forward a copy thereof to the AO. 3. The contents of this circular may be brought to the notice of all the officers working in your charge.

being...(nature of payment) to...(name & complete address of the person to whom the remittance has been made) after deducting a sum of Rs...being the tax @...which is the appropriate rate of tax deductible at source on the said amount of remittance.

2. A certificate from the accountant as defined in Explanation below Section 288 of the IT Act certifying the nature and amount of income, amount of tax payable and the amount actually paid, is also annexed.

3. In case it is found that the tax actually payable on the amount of remittance made has either not been paid or has not been paid in full, I/we undertake to pay the said amount of tax along with interest found due in accordance with the provision of the IT Act.

4. I/we will also be subject to the provisions of penalty and prosecution for the said default as per the IT Act.

5. I/we also undertake to submit the requisite documents etc. for enabling the IT Department to determine the nature and amount of income and tax, interest, penalty etc. payable thereon.

(The undertaking shall be signed by the person authorised to sign the return of income of the person making the payment).

8.9 The certificate from the chartered accountant to be filed along with the undertaking is reproduced as under: (Name, address and Permanent Account Number of person making the remittance) for ascertaining the nature of the remittance of...(amount of remittance) to...(Name and complete address of the person to whom the remittance is being made) and the rate at which the tax is deductible at source thereon and hereby certify that a sum of Rs...has been deducted as tax at the appropriate rate and has been paid to the credit of the Government.

8.10 From Circular No. 759 dt. 18th Nov., 1997 it can be noted that at the time of remittance, the only requirement on the part of the assessee (the remitter) is to file an undertaking along with a certificate of the accountant to the RBI, who in turn shall forward a copy thereof to the AO. CBDT in Circular No 767 dt. 22nd May, 1998 reiterated the requirements to be fulfilled as in earlier Circular No 759 dt. 18th Nov., 1997. However in para 4 of this circular it has been clarified that Circular No. 759 will cover those remittances for which RBI had prescribed the production of a no objection certificate from the IT authorities under the Exchange Control Manual. Further, if an order under Section 195(2) has been obtained by a person responsible for deducting tax, the new procedure of filing an undertaking along with a certificate prescribed in Circular No. 759 would not be applicable. Nothing has been produced before us by the Revenue that no objection certificate from IT authorities was required to be filed by the assessee. Again CBDT in Circular No. 10 of 2002 dt. 9th Oct., 2002 [(2002) 177 CTR (St) 41] reiterated the submitting of an undertaking along with a certificate from a chartered accountant before RBI at the time of the remittances to non-residents. In this circular new

formats of the undertaking by the assessee and certificate from an accountant have been prescribed. In undertaking furnished before RBI (a copy thereof to be forwarded to the AO by RBI), the assessee has to undertake the responsibility: 1. to pay the tax along with interest found due in accordance with the provision of the IT Act, in case it is found that the tax actually payable on the amount of remittance made has either not been paid or has not been paid in full; and will also be subject to the provisions of penalty and prosecution for the said default as per the IT Act.

2. to submit the requisite documents etc. for enabling the IT Department to determine the nature and amount of income and tax, interest, penalty etc. payable thereon.

From the format of the certificate to be issued by the chartered accountant, we also find that he is duty-bound to examine the books of account for ascertaining the nature of the remittance. The certificate contains the amount of remittance; name and complete address of the person to whom the remittance to be made; the rate at which the tax is to be deducted at source; the amount of tax deducted and credited to the Government. Under the new procedure, the Revenue can recover the tax along with interest, if any, from the assessee in a case the tax authorities later on find that short or no deduction of tax at source was made. The assessee is also liable for penalty/prosecution for the default committed by him.

Thus CIT w.e.f. 18th Nov., 1997 prescribed a new procedure for the purposes of the remittance of payments under which issue of no objection certificate under Section 195(2) by the IT authorities has been dispensed with.

8.11 However under Section 195(2) the person responsible for paying any such sum, other than salary, chargeable under the Act to a non-resident considers that the whole of such sum would not be income chargeable in the case of the recipient, he may make application to the AO to determine, by general or special order, the appropriate portion of such sum so chargeable, and upon such determination, tax shall be deducted under Sub-section (1) only on that proportion of the sum which is chargeable. Hon'ble Supreme Court in the case of Transmission Corporation of A.P. Ltd. v. CIT (supra) upheld the decision of Hon'ble Andhra Pradesh High Court by observing as under: "In this view of the

matter, the answers given by the High Court that (i) the assessee who made the payments to the three non-residents was under obligation to deduct tax at source under Section 195 of the Act in respect of sums paid to them under the contracts entered into; and (ii) the obligation of the respondent assessee to deduct tax under Section 195 is limited only to the appropriate proportion of income chargeable under the Act, are correct." Hon'ble Supreme Court has clearly laid down the principle that the obligation of the assessee to deduct tax under Section 195 is limited only to the appropriate proportion of income chargeable under the Act. This leaves no doubt in our mind that at the time of making payments of any sums to non-residents, the nature of the remittance has to be determined for the purposes of deduction of tax at source. CBDT in three circulars i.e. Circular No. 759 dt. 18th Nov., 1997; No. 767 dt. 22nd May, 1998; and No. 10 of 2002 dt. 9th Oct., 2002 have entrusted this task to the chartered accountant. Only in the cases where the person responsible for paying any such sum, other than salary, chargeable under the Act to a non-resident considers that the whole of such sum would not be income chargeable in the case of the recipient, he is obliged to make application to the AO under Section 195(2) to determine the appropriate portion of such sum so chargeable and tax shall be deducted under Sub-section (1) only on that proportion of the sum which is chargeable. Even in the cases where lower tax has been deducted or no tax deducted, the assessee by filing an undertaking before the RBI (addressed to the AO) has made himself liable not only for payment of tax on such remittances but also for penalty and prosecution for the defaults committed by him for non-deduction or lower deduction of tax at source. The contention of the learned Departmental Representative by placing reliance on the decision of Hon'ble Supreme Court in the case of Transmission Corporation of A.P.Ltd. (supra) that the assessee was under an obligation to make application to the AO under Section 195(2) of the Act for the determination of income and tax to be deducted, in our view, holds no water, as it runs contrary to the circulars issued by CBDT.8.12 Thus as discussed above the payments made to non-residents are neither in the nature of interest nor fee for technical services or royalty. The sums are not chargeable to tax under the Act as business income on the ground that none of the payee had PE in India. The memorandum explaining the Finance Bill, 2001 makes it clear that prior to amendment, the consideration for the use of, or

the right to use, industrial, commercial or scientific equipment was liable to be assessed as business income in the source country. Since the payment for use of space in servers is in nature of royalty and income arising on use of, or the right to use, industrial, commercial or scientific equipment was not royalty before the amendment by the Finance Act, 2001 w.e.f. 1st April, 2002, within the meaning of provisions of Explan. 2 to Section 9(1)(vi) of the Act, the same was to be assessed in other Contracting State i.e. USA as per para 1 of Article 12 of DTAA and not in India.

8.13 Another contention of learned Authorised Representative of the assessee is that the assessee is protected under Article 26(3) of DTAA. Article 26 of India-US DTAA deals with "Non-discrimination". Article 26(1) states that nationals of one Contracting State shall not be subjected in other Contracting State to any taxation or any requirement connected therewith which is much more burdensome than it is on the nationals of that other Contracting State. Article 26(2) provides against discrimination in the context of a PE in the other Contracting State. Article 26(3) is a general clause providing for indirect discrimination against a non-resident. It reads as below: Article 26(3) : Except where the provisions of para 1 of Article 9 (associated enterprises), para 7 of Article 11 (interest), or para 8 of Article 12 (royalties and fees for included services) apply, interest, royalties, and other disbursements paid by a resident of a Contracting State to a resident of a other Contracting State shall, for the purposes of determining the taxable profits of the first mentioned resident, be deductible under the same conditions as if they had been paid to a resident of the first mentioned State.

8.14 Apparently the provisions of para 1 of Article 9 (associated enterprises) and para 7 of Article 11 (interest) of DTAA are not applicable to facts of the case of the assessee. Para 8 of Article 12 (royalties and fees for included services) deals with a situation where, by reason of a special relationship between the payer and the beneficial owner or between them and some other person, an excess payment is made on account of royalties and fees for included services, such excess payment will be taxed according to laws of each Contracting State having due regard to the other provisions of the convention. In the case before us the parties are neither related nor is the issue relating to excess payment involved. Thus assessee's case

also does not fall under para 8 of Article 12 (royalties and fees for included services).

8.15 The provisions of Section 40(a)(i) as it stood prior to its amendment by the Finance (No. 2) Act, 2004 w.e.f. 1st April, 2005 applied to the payments by an assessee outside India to a non-resident only. Sub-clause (i), (ia) and (ib) of Clause (a) of Section 40 were substituted for Sub-clause (i) by the Finance (No. 2) Act, 2004 w.e.f.

1st April, 2005. While Sub-clause (i) still applies to the payments by an assessee outside India to a non-resident but Sub-clause (ia) applies to payments made to resident assesses. The terms "rent, royalty" were inserted in Sub-clause (ia) of Clause (a) of Section 40 by the Taxation Laws (Amendment) Act, 2006 with retrospective effect from 1st April, 2006. Thus w.e.f. 1st April, 2005, the provisions Section 40(a) apply equally both in the case of resident and non-resident except payments for rent and royalty which are applicable w.e.f. 1st April, 2006. In this appeal we are concerned with asst. yr. 2001-02. Therefore, the payment of royalty by the assessee is of the nature contemplated by the provisions of Article 26(3).

8.16 Now question arises as to whether the resident assessee could take advantage of provisions of Article 26(3) of DTAA. As already observed by us, the provisions of Section 40(a)(i) as it existed prior to its amendment by the Finance (No. 2) Act, 2004, w.e.f. 1st April, 2005 and subsequent amendment by the Taxation Laws (Amendment) Act, 2006 with retrospective effect from 1st April, 2006, provided, for disallowance of payments made to a non-resident only where tax is not deducted at source at the time of remittance. However, a similar payment to a resident does not result in disallowance in the event of non-deduction of tax at source. Thus a non-resident left with a choice of dealing with a resident or a non-resident in business would opt to deal with the a resident owing to the provisions of Section 40(a)(i) of the Act.

To this extent the nonresident is discriminated. Article 26(3) of Indo-US DTAA seeks to provide relief against such discrimination by saying that deduction should be allowed on the same condition as if the payment is made: to a resident. Thus this clause in DTAA neutralizes the rigour of the provisions of Section 40(a)(i) of

the Act. In this regard it would be relevant to refer to the provisions of Section 90(2) of the IT Act, 1961. It reads thus: 90(2) Where the Central Government has entered into an agreement with the Government of any other country outside India under Sub-section (1) for granting relief of tax. or as the case may be, avoidance of double taxation, then, in relation to the assessee to whom such agreement applies, the provisions of this Act. shall apply to the extent they are more beneficial to that assessee.

Hence by virtue of the provisions of Section 90(2), the law which is beneficial to the assessee to whom DTAA applies, should be followed.

This view is supported by the decision of Hon'ble Supreme Court in the case of Union of India v. Azadi Bachao Andolan (2003) 184 CTR (SC) 450 : (2003) 263 ITR 706 (SC). Hon'ble Supreme Court held as under: No provision of the DTAA can possibly fasten a tax liability where the liability is not imposed by the Act, the agreement may be restored to for negating or reducing it; and, in case of difference between the provisions of the Act and the agreement, the provisions of the agreement would prevail over the provisions of the Act and can be enforced by the appellate authorities and the Court.

Section 90 is specifically intended to enable and empower the Central Government to issue notification for implementation of the terms of a DTAA. The provisions of such an agreement, with respect to cases to which they apply, would operate even if inconsistency with the provisions of the IT Act. If it was not the intention of the legislature to make a departure from the general principles of chargeability to tax under Section 4 and the general principle of ascertainment of taxable income under Section 5, then there was no purpose in making those sections 'subject to the provisions of the Act'.

Section 90 was brought into the statute book prescribed to enable the executive to negotiate a DTAA and quickly implement it. Even accepting that the powers exercised by the Central Government under Section 90 are delegated powers of legislation, there is no reason why a delegatee of legislative power, in all cases, has no power to grant exemption. The delegate of a legislative power can exercise the power of exemption in a fiscal statute. When the requisite notification has been

issued under Section 90, the provisions of Sub-section (2) of Section 90 spring into operation and an assessee who is covered by the provisions of the DTAA is entitled to seek the benefits there under, even if the provisions of the DTAA are inconsistent with those of the Act.

8.17 We therefore hold that in view of the provision of Article 26(3) of DTAA, the AO cannot seek to invoke the provisions of Section 40(a)(i) of the Act for deduction while computing the profits and gains of business or profession. A similar view was taken by Tribunal Delhi Bench in the case of Herbalife International India (P) Ltd. (supra). To sum up, the payments made on account of rentals for hosting of websites on servers are not in nature of interest or royalties or fee for technical services or other sum chargeable to tax in India. CBDT has revised the procedure for deduction of tax at source on remittances made out of the country. The provisions of DTAA are also in favour of the assessee. Accordingly the assessee was not required to deduct tax at source under Section 195 of the Act while making payments outside India. We decide this issue in favour of the assessee.

9. The second issue for consideration relates to sustaining the addition of Rs. 3,31,252 on account of disallowance made under Section 14A of the IT Act, 1961. The AO disallowed administrative expenses relatable to earning of dividend income of Rs. 44,20,800. According to AO the amount of Rs. 3,31,252 was quantified by the assessee relatable to the dividend income.

9.1 On appeal, it was argued by the assessee that no expenses relating to dividend income were identified by the assessee and the entire expenditure was made for the purpose of business which was allowable under Section 37(1) of the Act. Another contention raised by the assessee was that there should be direct nexus between expenditure and dividend income so as to disallow the expenditure under Section 14A of the Act. The assessee placed reliance on the decision of Tribunal Bombay in the case of Mafatlal Holdings Ltd. v. Addl. CIT Learned CIT(A) observed that in the proceedings before the AO, the assessee allocated certain amount from the salary, contribution to provident fund and staff welfare based upon actual number of employees deployed in investment activity. General

expenses were also allocated by the assessee based on turnover in investment activity. The assessee has substantial investment portfolio acquiring, churning and maintenance of which would require management time and misc. administrative expenses. He further observed that in the case of business comprising of various activities, the principle of proportionate allocation of expenses could be validly applied in regard to the expenditure which could not be exclusively earmarked for a particular activity. The learned CIT(A) while deciding the issue held as under: 17. I am not convinced by the argument of the appellant. The appellant in proceedings before AO itself allocated certain amount from salary, contribution to PF and staff welfare based upon actual number of employees deployed in investment activity. General expenses were allocated by the appellant based on turnover in investment activity. The appellant had substantial investment portfolio, acquiring, churning and maintenance of which would require management time and miscellaneous administrative expenses.

In the case of business comprising of various activities, principle of proportionate allocation of expenses can be validly applied in regard to the expenditure which cannot be exclusively earmarked for a particular activity. Section 14A prescribes that expenditure in relation to income which does not form part of total income will not be allowed as a deduction. Supreme Court in the case of Naveen Chemicals Manufacturing and Trading Co. Ltd. v. Collector of Customs (1993) 4 SCC 430 recognized that phrase relation to is ordinarily of wide import. There is nothing in context of Section 14A to restrict the expenditure to direct nexus and in the case of varied activities, the only valid and reasonable basis for determining the expenditure relatable to exempt income is proportionate allocation of expenses as adopted by the AO. Supreme Court in the case of Waterfall Estates Ltd. v. CIT supports allocation of expenses for various sources of income. It is also relevant to mention that Supreme Court in the case of CIT v. United General Trust Ltd. had held to the effect that proportionate management expenses had to be deducted from the gross dividend for the purposes of relief under Section 80M. Therefore, principle of proportionate allocation was validly applied by the AO. 18. I respectfully beg to differ from the finding of the Tribunal in the case of Mafatlal Holding (supra) as Section 10(33) of the Act specifically provides that income in regard to dividend referred to in Section 115-0 of the Act shall not be included in

computing the total income of a previous year of any person. Further Section 14A of the Act provides that no deduction shall be allowed in respect of expenditure incurred by the assessee in relation to income which did not form part of the total income under the Act. Dividend by virtue of Section 10(33) did not form part of the total income under the Act for the appellant. The fact that the statute imposed liability on the company distributing the dividend cannot imply that dividend is taxed in the hands of the shareholder.

9.2 Before us learned Authorised Representation of the assessee submitted that the disallowance under Section 14A could be made in respect of amount actually incurred. He placed reliance on the decision of Tribunal Delhi Bench 'C in the case of Asstt. CIT v. Eicher Ltd. . He further submitted that Sub-section (2) and (3) of Section 14A are procedural and will not apply to earlier years. Me also placed reliance on the decision of Tribunal Bombay Bench in the case of Asstt CIT v. Citicorp Finance (India) Ltd. wherein it has been held that the AO was duty-bound to compute the disallowance on notional basis rather than pro rata basis, based on gross receipts of taxable income and exempted income. In this case the matter was restored to the file of AO to recompute the disallowance keeping in view the provisions of Section 14A(2) and 14A(3) of the Act which were inserted by Finance Act, 2006. He further submitted that CBDT has not prescribed any guidelines in this regard. On the other hand, learned Departmental Representative relied on the orders of the authorities below.

9.3 We have heard the rival submissions and perused the material available on record. The assessee has independent investment division which decides the issue relating to purchase and sale of investments.

The assessee has earned exempted income from dividend income from such investments made in the companies. Therefore, the administrative expenditure incurred on investment division has to be disallowed.

However the actual expenditure relatable to the exempted income out of expenditure incurred in relation to investment division can be disallowed. Since the AO has not carried out this exercise we feel it proper to set aside this issue to the file of the AO with the direction that he will ascertain the actual expenditure

incurred out of expenditure made on investment division which could be related for earning of exempted income. Such expenditure can be disallowed under Section 14A of the Act. The AO will decide the issue after affording the assessee a reasonable opportunity of being heard.

11. The next issue for consideration in ground No. 4 relates to disallowance of Rs. 1,43,387 on account of bad debts. The facts of the case stated in brief are that out of Rs. 1,43,387 an amount of Rs. 1,34,983 represented a loan given to Shri Rakesh Rai which was waived of on the request of the employee. The balance amount pertains to other employees. The assessee claimed these amounts as expenditure deductible under Section 37 of the Act. The AO was of the view that advances to employees could not be termed as expenditure as they were not payments in lieu of services rendered and were loan amount which did not pertain to the year under consideration. The AO also noted that advancing of loan was not the business of assessee. The AO relied on the decision of Hon'ble Madras High Court in the case of Palani Andavar Mills Ltd. v. CLT wherein it was held that the advances made to employees and subsequently written off were not allowable as business expenditure.

11.1 Before learned CIT(A) it was argued that the amount advanced by the assessee in the course of business which could not be recovered from employees was business expenditure. The reliance was placed on the decision of Hon'ble J&K High Court in the case of Clenab Forest Co. v. CIT. It was also explained that the decision of Hon'ble Madras High Court in the case of Palani Andavar Mills Ltd. (supra) was distinguishable to the facts of the assessee's case. The assessee had given advance of Rs. 2,50,000 on 6th June, 2000 to Shri Rakesh Rai to be recovered over a period of five years but since Shri Rai submitted resignation in December, 2000 when the amount of Rs. 2,04,983 was irrecoverable and since the assessee due to recession wanted to reduce its overhead expenses it accepted Rs. 70,000 thereby waiving Rs. 3,34,983. Likewise, it was claimed that the balance amount could not be recovered from various employees who left the services.

11.2 Learned CIT(A) after examining the contention of assessee and appreciating the facts of the case held that the amount written off in the case of Shri Rakesh Rai was in nature of loan which could not be classified as business expenditure in view of decision of Hon'ble Madras High Court in the case of Palani Andavar (supra). Likewise writing off impressed account in respect of advances was not expenditure qualifying for deduction under Section 37(1) of the Act.

The case of Chenab Forest Co. (supra) was distinguishable. Accordingly, learned CIT(A) upheld the stand taken by the AO.11.3 Before us it has been submitted that the amounts written off are business expenses. The advances were given during the course of business proceedings. The amount was written off as due to business expediency. In the case of Palani Andavar (supra) no business expediency was shown and therefore Hon'ble Madras High Court in the case of CJT v. Simpson and Co. Ltd. wherein it has been held that payment made for purpose of retrenchment of assessee for reducing the staff and to bring about reduction in the wage bill was held to be allowable deduction. He also placed reliance on the decision of Hon'ble Supreme Court in the case of K. Ravindranathan Nair v. CIT (2000) 164 CTR (SC) 498 : (2001) 247 ITR 178 (SC) wherein the amount paid under settlement was held to be expenditure incurred in the course of business. The imprest account with the employees who left the services was a loss and therefore the same was allowable as deduction.

On the other hand, learned Departmental Representative submitted that it was loan given to various employees and therefore could not be treated as expenditure allowable under Section 37 of the Act. He placed reliance on the decision of learned CIT(A).

11.4 We have heard the rival submissions and perused the material available on record. Admittedly the amount of Rs. 1,43,387 written off in the books of accounts pertains to the advance given to the employees in earlier years. The amount has been claimed on account of business expediency. The cases relied upon by the assessee relate to amount written off at the time of voluntary retirement as retrenchment compensation paid or amount paid under settlement with the trade unions. Nothing has been brought on record that the amount was written off on

account of implementation of voluntary retirement scheme or was part of retrenchment compensation based on the agreement arrived at with the trade unions. The amount written off represents the loans advanced in earlier years. No material has been brought on record to prove the business expediency and therefore the loan given to various employees in earlier years and writing off the same will not constitute the expenditure incurred for the purpose of Section 37(1) of the Act.

Accordingly, we do not find any infirmity in the order passed by authorities below.

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