Under Art 26(3) of India-USA DTAA payments to Non-Residents are equated with payments to Residents & so s. 40(a)(i) disallowance not valid

(ITAT Mumbai) Central Bank of India vs. DCIT

The assessee made payments to Master Card and VISA Card, international credit card companies, based in USA, for services in respect of credit cards issued by the assessee. As the assessee had **not deducted tax at source on payments** made, the AO **disallowed the claim** of deduction u/s **40(a)(i)**. The CIT (A) upheld the disallowance on the ground that VISA & Mastercard had a permanent establishment in India through the networking computers and leased telephone lines and the sums paid to them were taxable in India. In appeal before the Tribunal, the assessee raised the alternative argument 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 the India-USA DTAA which protects the non residents against any discrimination vis-à-vis residents. HELD allowing the appeal:

Article 26(3) of the India-USA DTAA protects the interest of non residents vis-a-vis residents. Article 26(3) provides that payment made to a non-resident will be deductible under the same conditions as if the payment were made to a resident. The exceptions provided in Article 26(3) are not applicable on facts. As per s. 40(a)(i), no disallowance can be made in respect of payments to residents on the ground of non-deduction of tax at source. Therefore, **in view of Article 26(3), no disallowance can be made even in case of payments to non-residents even if the amount is found taxable in India in their hands**. **Herbal Life International** 101 ITD 450 (Del) followed.

IN THE INCOME TAX APPELLATE TRIBUNAL

"F" Bench, Mumbai

Before Shri D. Manmohan (VP) and Shri Rajendra Singh(AM)

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

Central Bank of India The Dy.CIT Special Range 27

Attn: Central Accounts Dept. (B/S) Mumbai

Chander Mukhi, 4th floor,

Nariman Point, Mumbai 400 021.

Appellant Respondent

Assessee by : Shri Farrokh Irani

Revenue by : Shri Pavan Ved

ORDER

PER RAJENDRA SINGH (AM)

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.

2. 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 (viia) 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 (viia) 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. 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-*

2. 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.

2.2 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.

2.3 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 Vs 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 (viia) 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.

3. 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 XVIIB 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.

3.1 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.

3.2 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-à-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."

3.3 The Learned AR placed reliance on the decision of tribunal in case of Harbalife International India Pvt. Ltd. Vs 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.

3.4 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.

4. In the result all the appeals of the assessee are allowed in terms of the order above.

5. The order was pronounced in open court on 24.09.2010.

Sd/-	**Sd/-**
(D. MANMOHAN)	**(RAJENDRA SINGH)**
VICE PRESIDENT	**ACCOUNTANT MEMBER**

Date: 24.09.2010