

**IN THE INCOME TAX APPELLATE TRIBUNAL,
KOLKATA 'B' BENCH, KOLKATA**

[Before Shri Pramod Kumar AM and Shri Mahavir Singh JM]

I.T.A. No.: 1402/ Kol. / 2011
Assessment year : 2003-04

**Deputy Commissioner of Income Tax
Circle 8, Kolkata**

.....**Appellant**

Vs.

Rajrani Exports Pvt Ltd
7A, Pretoria Street, Kolkata 700 071
[PAN : AABCR8968E]

.....**Respondent**

Appearances by:

Niraj Kumar, *for the appellant*

Pawan Kumar Agarwal, *for the respondent*

Date of reserving the order : May 22, 2012

Date of pronouncing the order : May 31, 2012

ORDER

Per Pramod Kumar:

1. By way of this appeal, the appellant Assessing Officer has challenged correctness of learned Commissioner (Appeals)'s order dated 19th August 2011, in the matter of assessment under section 143(3) r.w.s. 147 of the Income Tax Act, 1961 (hereinafter referred to as 'the Act'), on the following ground:

1. That on the facts and circumstances of the case and in law, the learned CIT(A) erred in deleting the disallowance of Rs 1,28,45,058 made by the Assessing Officer in relation to assessment year 2003-04.

2. That, on the facts and circumstances of the case and in law, the learned CIT(A) erred in holding that the payment of Rs 1,28,35,058 was not any kick back money paid by the assessee

to M/s Alia Transportation and General Trading Co of Iraq, but a legitimate business expenses in the form of commission paid to the Iraqi party, in relation to the assessment year 2003-04.

2. Briefly stated, the material facts are like this. The assessee is, *inter alia*, engaged in the business of manufacturing, processing and exports of rice and tea. During the relevant financial period, the assessee had exported tea to Iraq under the 'Oil for Food Program', as sanctioned by the United Nations through its resolution no. 661 of 1990 and as administered by the UN. In broad terms, under the OFP, Iraq was allowed to sell a limited specified quantity of oil, and sale proceeds of the oil were to be deposited in an escrow account, out of which a major portion of the sale proceeds could be used by Iraq for meeting its purchases of goods on humanitarian grounds. The assessee was subjected to scrutiny assessment, and, subsequent to the finalization of scrutiny assessment, its assessment was reopened. As assessee's grievance against the initiation of reassessment proceedings has been rejected by the CIT(A) and the assessee is not in cross appeal or cross objection against the said CIT(A)'s order, we need not really deal with the facts leading to reassessment proceedings. Suffice to say that the assessment was re-opened, and in the course of assessment so re-opened, the commission of Rs 1,28,45,058 paid to one Alia Transportation and General Trading Co was disallowed on the short ground that , as per Volcker Committee report, the payments made to this company were "**illegal payments in the nature of kick-backs, which were ultimately received by the Iraqi authorities**" and "**as the amounts paid by the assessee are illegal and prohibited by the law of the land, the same cannot be allowed as expenses under the Income Tax Act, 1961**". The Assessing Officer further noted that his requisition to the assessee to explain the position with regard to these payments has not been complied with. It was in this background that the sum of Rs 1,28,45,058 was disallowed. Aggrieved, assessee carried the matter in appeal before the CIT(A). Learned CIT(A),

after extensively reproducing from the statement of facts and written submissions of the assessee, referred to this Tribunal's decision in the case of **TIL Ltd Vs ACIT (16 SOT 33)** and observed that the "Tribunal had dealt with the identical situation wherein the assessee exported Forklift Trucks to Iraq and export commission was disallowed by the AO on similar grounds" and the disallowance was deleted by the Tribunal by holding that "the commission paid on account of services duly rendered by the commission agent was allowable as a deduction in computation of appellant's (*assessee's*) total income". Learned CIT(A) then proceeded to delete the impugned disallowance and observed as follows:

"It is observed that the commission on export activity had been fully disclosed in all correspondences and activities in relation to export, the commission was paid through the banking channels of RBI approval and it was paid pursuant to an agreement approved by the Government of India and UN. The payment of commission was for business consideration and there was apparently no illegality in making payment of commission. Besides this, nothing has been brought on record to show that the transactions relating to payment of commission are non genuine or are excessive and unreasonable. The Volker Committee had discussed about in utilization of money by the recipient of the recipient of commission in parting some of the funds so received as commission with the Government of Iraq was objected to by Volker Commission report which was a pact between the Iraq Government and the UN, wherein it appears that neither the appellant company nor the Government of India is involved.

In view of the above and respectfully following the decision of the Hon'ble Kolkata Tribunal in the case of TIL Ltd Vs ACIT (supra), I hold that the entire disallowance on this account is allowable and, therefore, the order of the AO is reversed to that extent".

3. The Assessing Officer is aggrieved of the relief so granted by the CIT(A) and is in appeal before us.

4. We have heard the rival contentions, perused the material on record and duly considered factual matrix of the case as also the applicable legal position.

5. To properly appreciate the controversy requiring our adjudication in this appeal, it is necessary to take note of some background facts relating to the issue in appeal. There is no dispute that the assessee had made exports to Iraq under the 'Oil for Food Program', which was meant to mitigate the hardships to ordinary Iraqi citizens as a result of harsh trade sanctions against Iraq, as a result of its invasion of Kuwait. The assessee himself has stated, in the statement of facts, that the exports were made under the Oil for Food Program under the United Nations monitoring. It will, therefore, be useful to understand the manner in which this program worked. The working of this program can be appreciated from the following document on UN website:

Oil-for-Food

<http://www.un.org/Depts/oip/background/index.html>

Origins: In August 1990 the Security Council adopted resolution 661, imposing comprehensive sanctions on Iraq following that country's invasion of Kuwait. In the immediate aftermath of the Gulf War in 1991, the Secretary-General dispatched an inter-agency mission to assess the humanitarian needs arising in Iraq and Kuwait. The mission visited Iraq from 10 to 17 March 1991 and reported that "the Iraqi people may soon face a further imminent catastrophe, which could include epidemic and famine, if massive life-supporting needs are not rapidly met." (S/22366, para. 37). Throughout 1991, with growing concern over the humanitarian situation in the country, the United Nations proposed measures to enable Iraq to sell limited quantities of oil to meet its people's needs. The Government of Iraq declined these offers, contained in particular, in resolutions 706 (1991) and 712 (1991), adopted, respectively, in August and September 1991.

Resolution 986: On 14 April 1995, acting under Chapter VII of the United Nations Charter, the Security Council adopted resolution 986, establishing the "oil-for-food" programme, providing Iraq with another opportunity to sell oil to finance the purchase of humanitarian goods, and various mandated United Nations activities concerning Iraq. The programme, as established by the Security Council, is intended to be a "temporary measure to provide for the humanitarian needs of the Iraqi

people, until the fulfillment by Iraq of the relevant Security Council resolutions, including notably resolution 687 (1991) of 3 April 1991".

Agreement: Although established in April 1995, the implementation of the programme started only in December 1996, after the signing of the Memorandum of Understanding (MOU) between the United Nations and the Government of Iraq on 20 May 1996 (S/1996/356). The first Iraqi oil under the Oil-for-Food Programme was exported in December 1996 and the first shipments of food arrived in March 1997.

Funding: Until 20 March 2003, when war intervened and oil exports under the programme ended, the Oil-for-Food Programme was funded exclusively from the proceeds of Iraqi oil exports, authorised by the Security Council.

In the initial stages of the programme, Iraq was permitted to sell \$2 billion worth of oil every six months, with two-thirds of that amount to be used to meet Iraq's humanitarian needs. In 1998, the limit on the level of Iraqi oil exports under the programme was raised to \$5.26 billion every six months, again with two-thirds of the oil proceeds earmarked to meet the humanitarian needs of the Iraqi people. In December 1999, the ceiling on Iraqi oil exports under the programme was removed by the Security Council.

Seventy two per cent of Iraqi oil export proceeds funded the humanitarian programme, of which 59% was earmarked for the contracting of supplies and equipment by the Government of Iraq for the 15 central and southern governorates and 13% for the three northern governorates, where the United Nations implemented the programme on behalf of the Government of Iraq. The balance included 25% for a Compensation Fund for war reparation payments; 2.2% for United Nations administrative and operational costs; and 0.8% for the weapons inspection programme.

Management: The Office of the Iraq Programme is headed by the Executive Director who is responsible for the overall management and coordination of all United Nations humanitarian activities in Iraq under resolutions 661 (1990) and 986 (1995) and the procedures established by the Security Council and its Committee set up by resolution 661 (1990), as well as the Memorandum of Understanding between the United Nations and the Government of Iraq (May 1996).

Mandate: The Office of the Iraq Programme administers the programme as an operation separate and distinct from all other United Nations activities within the context of the sanctions regime, which fall within the purview of UNMOVIC, IAEA and the United Nations Compensation Commission.

Coordination: The Office of the Humanitarian Coordinator in Iraq (UNOHCI) is an integral part of the Office of the Iraq Programme (OIP). The Humanitarian Coordinator in Iraq reports directly to the Executive Director of OIP, and is responsible for the management and implementation of the programme in the field.

Implementation: There are nine United Nations agencies and organizations involved in the programme. They are: FAO, UNESCO, WHO, ITU, UNICEF, UNDP, WFP, UNOPS, UN-Habitat.

Delivery: As of 28 May 2003, some \$28 billion worth of humanitarian supplies and equipment had been delivered to Iraq under the Oil-for-Food Programme, including \$1.6 billion worth of oil industry spare parts and equipment. An additional \$10 billion worth of supplies were in the production and delivery pipeline.

Performance: The latest report of the Secretary-General on the Oil-for-Food Programme was issued on 12 November 2002 (S/2002/1239). It focuses on improvements, shortcomings and difficulties in the humanitarian situation in Iraq; a revenue shortfall in the programme; and an assessment of the implementation of the new set of procedures for the processing and review of contracts for humanitarian supplies. The new procedures were introduced under Security Council resolution 1409 (2002), based on the Goods Review List (GRL). It is the first such assessment since the adoption of that resolution.

Oil-for-Food Plus: The Programme, as outlined in the latest report of the Secretary-General, was expanded by the Security Council beyond its initial emphasis on food and medicines to include infrastructure rehabilitation and 24 sectors: food, food-handling, health, nutrition, electricity, agriculture and irrigation, education, transport and telecommunications, water and sanitation, housing, settlement rehabilitation (internally displaced persons - IDPs), mine action, special allocation for especially vulnerable groups, and oil industry spare parts and equipment. The Government of Iraq introduced the following 10 new sectors in June 2002: construction, industry, labour and social affairs, Board of Youth and Sports, information, culture, religious affairs, justice, finance, and Central Bank of Iraq.

Pre-War and Post-War Developments (2003): On 17 March 2003, the United Nations Secretary-General announced that in view of warnings received from the Governments of the United Kingdom and the United States, regarding the prospect of war and the continued safety and security of UN personnel present in the territory of Iraq, he was no longer in a position to guarantee their safety and security. All remaining UN international staff in Iraq were evacuated on 18 March 2003 and the President of the Security Council asked the Secretary General to submit proposals to adjust the mandate of the Oil-for-Food Programme so that it would have flexibility to meet new humanitarian challenges presented by the prospect of war in Iraq.

On 19 March 2003, the war in Iraq began with the bombing of Baghdad and on 20 March 2003, the Secretary General pledged to do his utmost to ensure that the UN rose to the challenge of shielding the civilian population "from the grim consequences of war."

A resolution (1472) was adopted unanimously by the Security Council on 28 March 2003 adjusting the Oil-for-Food Programme and giving the Secretary-General

authority to facilitate the delivery and receipt of goods contracted by the Government of Iraq for the humanitarian needs of its people. On 24 April 2003 those provisions were extended to 3 June. The extension under resolution 1476,(2003) gave the Office of the Iraq Programme and UN agencies, valuable time to identify and ship additional goods and supplies.

The Security Council lifted civilian sanctions on Iraq on 22 May with the adoption of resolution 1483 (2003). The resolution also gave the Secretary-General authority to appoint a Special Representative to work with the occupying forces in rebuilding Iraq; opened the way for the resumption of oil exports, with revenues deposited in a Development Fund for Iraq held by the Central Bank; and provided for the termination of the Oil-for-Food Programme within six months, transferring responsibility for the administration of any remaining Programme activities to 'the Authority' representing the occupying powers. The Council has called on the United Nations to assist the Iraqi people, in coordination with 'the Authority', in a wide range of areas, including humanitarian relief, reconstruction, infrastructure rehabilitation, legal and judicial reforms, human rights and the return of refugees, and also to assist with civilian police.

In its "phasedown" prior to closure on 21 November 2003, the Office of the Iraq Programme, in coordination with UN agencies and programmes, the Coalition Provisional Authority (CPA) and Iraqi authorities, has continued to identify and ship approved and funded priority items in a pipeline of humanitarian goods and supplies valued at some \$10 billion. As of 4 November 2003, consultations between the Coalition Provisional Authority, Iraqi experts and the United Nations, had resulted in the prioritization of 3,168 contracts valued at more than \$8.5 billion. (Updated 4 November 2003)

(Emphasis by underlining supplied by us)

6. To the extent relevant for our purposes, the FFOP worked like this. The Iraqi Government was allowed to export oil but the sale proceeds were to be deposited in an escrow account, and these sale proceeds were to be partly, though substantially, used for importing goods, on humanitarian grounds, for Iraq people. The goods so allowed to be imported were foodstuff, medicines and other necessities for day to day life of ordinary people. The manner in which program worked came up for sharp criticism for its functioning, and there were allegations of massive irregularities, kickbacks and corruption in its functioning. It was in this backdrop that an enquiry commission, named as 'Independent Inquiry Committee' headed by Paul A. Volker, a former Chairman of United States

Federal Reserve, researched possible corruption in this Iraqi Oil for Food Program. The terms of reference of this inquiry were as follows:

The independent inquiry shall collect and examine information relating to the administration and management of the Oil-for-Food Programme, including allegations of fraud and corruption on the part of United Nations officials, personnel and agents, as well as contractors, including entities that have entered into contracts with the United Nations or with Iraq under the Programme:

(a) to determine whether the procedures established by the Organization, including the Security Council and the Security Council Committee Established by Resolution 661 (1990) Concerning the Situation between Iraq and Kuwait (hereinafter referred to as the "661 Committee") for the processing and approval of contracts under the Programme, and the monitoring of the sale and delivery of petroleum and petroleum products and the purchase and delivery of humanitarian goods, were violated, bearing in mind the respective roles of United Nations officials, personnel and agents, as well as entities that have entered into contracts with the United Nations or with Iraq under the Programme;

(b) to determine whether any United Nations officials, personnel, agents or contractors engaged in any illicit or corrupt activities in the carrying out of their respective roles in relation to the Programme, including, for example, bribery in relation to oil sales, abuses in regard to surcharges on oil sales and illicit payments in regard to purchases of humanitarian goods;

(c) to determine whether the accounts of the Programme were in order and were maintained in accordance with the relevant Financial Regulations and Rules of the United Nations

(www.iic-offp.org/reference.htm)

7. There were many significant and controversial findings in this report. One very important aspect of this report was about 'non-contractual beneficiaries' of oil allocation by Iraqi regime, and these allocations or quotas granted by the Iraqi regime were perceived as *de facto* bribe payments by the Iraq regime. That aspect, however, does not touch the issue in appeal before us. There were also findings to the effect that Iraqi regime used several front companies, which entered into agreements with the exporters and collected amounts for 'after sales

service', 'inland transportation fees', 'commission' etc, and the amounts so collected by these front companies were passed on as kickbacks to Iraqi regime. This is the area which concerns the issue in this appeal before us, as the disallowance before us pertains to the commission payment by the assessee, in the form of 'inland transportation fees' and 'after sales service', to a company by the name of Alia Transportation and General Trading Co. Interestingly, this company, i.e. Alia Transportation and General Trading Co., finds a prominent mention in the final report issued by the IIC. According to the IIC report, which is popularly known as Volker Committee Report, Alia was a key player in the irregularities relating to Oil for Food Program administered by the United Nations. Volker Committee report (www.iic-offp.org) describes Alia as one of the 'Iraqi Front Companies' and states, at page 309, as follows:

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VII: IRAQI FRONT COMPANIES

Three of the major Iraqi front companies were: (1) Alia for Transportation and General Trade (“Alia”) of Jordan; (2) Al-Hoda International Trading Co. (“Al-Hoda”) of the United Arab Emirates; and (3) Al Wasel & Babel General Trading LLC (“Al Wasel & Babel”) of the United Arab Emirates. Each of these companies is discussed in turn.

A: Alia for Transportation and General Trade:

Alia was established in August 1994 as a joint venture between Hussain Al-Khawam, an Iraqi businessman, and the Iraqi Ministry of Transportation. This arrangement developed from a proposal by Mr. Al-Khawam to refurbish Iraqi vessels stranded off the coast of Jordan and to use them for commercial shipping. At the time of Alia's registration, Jordanian law required that at least one owner of a Jordan-registered company be a Jordanian national. As a result, Mr. Al-Khawam nominated a close associate, Mo'tasset Fawzy Qatishat, to hold fifty-one percent of the company's shares on Mr. Al-Khawam's behalf. The Iraqi Ministry of Transportation assigned two of its employees to hold Alia's remaining shares.

In 1999, the Ministry of Transportation arranged with Alia to have it act as ISCWT's (Iraq State Company for Water Transport) collection agent for suppliers' payments for the inland transportation of goods arriving at the port of Umm Qasr. As collection agent, Alia received a small commission on the funds it channeled from suppliers to ISCWT. According to bank records, Alia began receiving fees from suppliers as early as March 2000.

The agent arrangement with Alia was useful to the Government of Iraq. As noted in Section II.B above, Alia violated and assisted in violating the United Nations sanctions regime, which prohibited any third party from engaging in financial transactions with the Government of Iraq except as permitted under the Programme or Security Council resolutions. By arranging for suppliers to make illicit payments to a Jordanian company such as Alia—instead of directly to ISCWT or another governmental entity of Iraq—the Iraqi regime disguised the illicit nature of such payments. 498

In fact, all transportation services for which Alia received payment from humanitarian suppliers were provided by employees of the Government of Iraq. Transport of goods arriving at Umm Qasr was provided by trucks from the Ministry of Transportation or the Iraqi Grain Board (“IGB”). When asked how much of the fees paid by Alia to ISCWT were used for the true costs of transport, Alia’s general manager stated: “There were no actual costs. The driver got maybe \$10. This was a payment to the Government of Iraq.” Alia’s general manager was unaware whether the actual costs for transport had any bearing on the transportation fee charged and collected by Alia.

Following the conclusion of contract negotiations between an Iraqi purchasing body and a supplier, ISCWT contacted Alia by fax, letter, or telephone and informed Alia of the amount that was to be received from the supplier. On some occasions, ISCWT contacted the supplier directly to advise the supplier that it should send payment to Alia or sent the same invoice to the supplier that it sent to Alia. On other occasions, Alia sent invoices to suppliers indicating the amounts levied by ISCWT. Representatives of ISCWT came to Alia’s office every month to inspect the company’s records, and ISCWT also sent an employee to work at Alia.

Suppliers paid their fees in various foreign currencies (not Iraqi dinars) to Alia’s accounts at Jordan National Bank and the Egyptian Arab Land Bank. Upon receipt of the funds, Alia informed ISCWT of the amount of the transfer and the corresponding supplier, contract, ship, and letter of credit. Below is one such example of a letter from Alia to ISCWT, advising ISCWT of its receipt of payment on ISCWT’s behalf:

(Translated from Arabic- Page 1 of 1)

Alia Company for Transportation and General Trade

No. F8/5087/2002

Date : 20/11/2002

To : State Company of Water Transport, Basra

Attn : Ms Elham, Marine Agencies

Sub : MV Makram

Greetings !

We would like to inform you that the amounts below have been received from Jawala Company for internal transportation and after sales service

fees for 2329.1897 m3 of wood ; LC No. V734538, bill of lading no PK/Iraq/001, based on the following:

\$ 60,225.31 for internal transportation fees

€236,477.40 for after sales service

We thank you for your cooperation with us.

With utmost respect and appreciation,

Financial/ Haitham El- Zobi

Copy to : State Water Transport Co, Baghdad
Baghdad Ships, Shipping Department

Shortly after sending such communications, Alia transferred the full payment amount (less a commission between one-quarter percent and one percent) to ISCWTC's account at Rafidain Bank in Amman. For these transfers, Alia used accounts in various foreign exchange currencies. In total, between March 2000 and December 2003, the payments passing through Alia's bank accounts in Jordan National Bank amounted to a USD equivalent of more than \$788 million.

Apart from acting as a collection agent, Alia also engaged in five sales contracts under the Programme. During Phase VIII of the Programme, Alia contracted to supply Toyota vehicles and spare parts. For these two contracts, Alia paid a total of \$1,246,072 in after-sales-service fees (in cash and in kind) and \$90,900 in inland transportation fees, totaling \$1,336,972. With respect to one of these contracts, COMM no. 800929, Alia disputed the characterization of its payment as an "after-sales-service" fee, referring to the payment merely as an "extra fee." Additionally, Alia advised that it inflated the price of this contract by more than \$4,000 per vehicle at the Government of Iraq's request and then used the extra revenue to purchase fifty more vehicles that it shipped without inspection to Iraq. 503

In summary, based on the available evidence, Alia knowingly acted as a front company, serving as a conduit for collecting hundreds of millions of dollars in illicit fees paid by suppliers to the Iraqi regime. Alia further made illicit payments totaling \$1,336,972 in connection with its own contracts under the Programme."

8. There is thus reasonable material, by way of Volker Committee report, to indicate that no services were actually rendered by Alia which actually worked as a conduit for Iraqi regime on a wafer thin margin of 0.25% to 1.00%. The balance amount, ranging from 99% to 99.75% of the amounts paid to Alia, was transferred to Iraqi regime as an illegal

kickback. The assessee has all along laid a lot of emphasis on the claim that a copy of the Volker Committee report has never been supplied to the assessee which is, to quote the words of the assessee, 'in clear violation of the well settled principles of natural justice, equity and fair play' but this plea is too naïve to be accepted. The Volker Committee is freely available on the internet, is fully in public domain and anyone can access it. Having said that, we must quickly add that merely because this report states that the amounts paid to Alia were actually kickbacks to Iraqi regime, that fact *per se* would not render the expenditure so incurred, if otherwise deductible, as non-deductible in computation of business income, unless these payments are hit by some other disabling provisions of the Income Tax Act. What is to be examined first is whether the amounts so paid are deductible business expenditure in the first place, and if so, whether these amounts are hit by any disabling provisions under the Act. Let us, therefore, take a quick look at the scheme of the Act from this perspective to deal with this aspect of the matter. Section 37(1) of the Act provides that **"any expenditure (not being expenditure of the nature described in sections 30 to 36 and not being in the nature of capital expenditure or personal expenses of the assessee), laid out or expended wholly and exclusively for the purposes of the business or profession shall be allowed in computing the income chargeable under the head "Profits and gains of business or profession".** Explanation to Section 37(1), which qualifies this general deduction, provides that, **"For the removal of doubts, it is hereby declared that any expenditure incurred by an assessee for any purpose which is an offence or which is prohibited by law shall not be deemed to have been incurred for the purpose of business or profession and no deduction or allowance shall be made in respect of such expenditure".** It follows that any payment, which is prohibited by law, is not an admissible deduction under the scheme of the Act. That takes us to the question whether payment to Alia, on the facts of this case, could be said to be prohibited by law.

9. As far as the assessee is concerned, what is really important is the purpose for which the assessee has made the payment. The purpose for which the assessee has made the payment is evident from the appointment letter of agent, a copy of which is placed at page 132 of the paper-book, which sets out the Alia's obligations as follows:

17th July 2001

**Alia Transportation and General Trading Co
Iraq**

Sir,

This is in response to enquiry floated for supply of tea to Iraq under 'Oil for food program'. Please find mentioned herein the services to be rendered by you against payment of after sales service/commission to be decided mutually:

- a) make enquiries in the Ministry of Trade, State Company for foodstuff trading, Baghdad, Iraq, as to their requirement of the black tea;**
- b) collect copy of the tender, as and when floated by the said Ministry, and send the same to us to submit the tender documents to the concerned authorities in the Ministry on our behalf;**
- c) negotiate the tender prices with Ministry officials, and obtain clearances regarding the prices, terms and conditions etc, in consultation with us;**
- d) follow up with the Ministry opening of letters of credit (L/Cs) after registration of contract with UN authorities, so that shipment could start from India;**
- e) liaise and follow up with shipping line at Iraq regarding arrival of each consignment, so as to ensure that arrival report/ standardised confirmation is sent to the UN Security Council's office at Um Qaser Port, Iraq;**
- f) arrange transportation of export consignment from the overseas port of embarkation after destuffing/ stuffing to all Iraqi Governorates /Provinces/Warehouse, as specified in the respective orders, by trucks;**

- g) **arrange early inspection and internal approval of each consignment by the concerned ministry authorities, including the prescribed UN agencies;**
- h) **follow up with the UN security council office at Iraq for expediting the arrival report to be sent to the UNO office at New York, for releasing the payments; and**
- i) **to do such acts and things as required for execution of the order procured and realization of export proceeds.**

Thanking you,

**Sd/xx
f. Rajrani Exports Limited**

10. Alia has confirmed the above understanding and, vide letter dated 25th July 2001, stated that, **“We hereby confirm that we will do all such activity on your behalf, from procurement of order to final realization of export proceeds to you on a fees to be charged against each export bill as raised by you”** and that **“the fees will be mutually decided and shall not be more than 10% of the order value”**. It is also important to bear in mind the fact that Alia was a Jordanian company and, therefore, the transactions between the assessee and Alia were not hit by any UN sanctions either. Revenue has not pointed out any specific violation of law beyond alleging that these payments were actually kickbacks for Iraqi regime, but then so far as the character of these payments being kickback is concerned, that was between Alia and Iraqi regime and these were the transactions between Alia and Iraqi regime which could be termed as illegal and in violation of UN sanctions. The illegality, if at all, therefore, was that the payments were made by the exporters ended up with Iraqi regime, which was in violation with the UN sanctions. The stage at which this illegality occurred was the *inter se* transaction between Alia and Iraqi regime – something over which the assessee had no control. As noted by the Volker Committee report itself, **“Alia violated and assisted in violating the United Nations sanctions**

regime, which prohibited any third party from engaging in financial transactions with the Government of Iraq except as permitted under the Programme or Security Council resolutions. By arranging for suppliers to make illicit payments to a Jordanian company such as Alia—instead of directly to ISCWT or another governmental entity of Iraq—the Iraqi regime disguised the illicit nature of such payments” but then that aspect of the matter is not really material for us. In order to invoke Explanation to Section 37(1), it is necessary that the assessee’s payment should be for a purpose which is an offence or which is prohibited by law. What the recipient of this payment does is hardly important from this perspective. The illegality has supervened at the stage at which the Alia has paid the money to Iraqi regime in violation of UN sanctions against Iraq, but that that is the stage at which assessee has no control over the matter. It is not even a finding by the Volker Committee that the exporters making payments for the ‘inland transportation fees’ or ‘after sales service’ always knew that the monies will be used for the purposes of kickbacks to the Iraqi regime. As a matter of fact, these manoeuvrings were designed by the Iraqi regime and the front companies were set up by the Iraqi regime. The exporters had no role in devising these innovative mechanism to raise them monies. The Volker Committee itself acknowledges the fact that “**these payments to the Iraqi regime were disguised by various subterfuges and were not reported to the United Nations by Iraq or to the participating contractors...** (like the assessee before us) **let alone approve by the United Nations as permissible payments from escrow account.**” When it is not even the case made out in the Volker Committee report that the participating exporters in the OFFP, like the assessee before us, were all along aware about the fact that these front companies, to one of which he has made the payments, are nothing more than conduits for Iraqi regime, this report can not be lead to the Assessing Officer’s finding that the payments were made for the kickbacks to the Iraqi regime. We may, in

this regard, refer to the following observations made by the Volker Committee report at pages 249-250:

Iraq's largest source of illicit income in relation to the Programme came from "kickbacks" paid by companies that it selected to receive contracts for humanitarian goods. **These payments to the Iraqi regime were disguised by various subterfuges and were not reported to the United Nations by Iraq or the participating contractors**—let alone approved by the United Nations as permissible payments from the escrow account. As set forth in the Committee's recent Programme Management Report, available evidence indicates that Iraq derived more than \$1.5 billion in income from these kickbacks.

As with its selection of oil purchasers, political considerations influenced Iraq's selection of humanitarian vendors. For the first several years of the Programme's operation, however, Iraq did not have in place a formal kickback policy. The kickback policy emerged only over time as the Programme extended for a longer period and involved larger amounts than anticipated. The kickback policy developed in mid-1999 from Iraq's effort to recoup **purported costs it incurred to transport goods to inland destinations after their arrival by sea at the Persian Gulf port of Umm Qasr. Rather than seeking approval from the United Nations for compensation of such costs from the Programme's escrow account, Iraq simply required humanitarian contractors to make such payments directly to Iraqi-controlled bank accounts or to front companies outside Iraq that in turn forwarded the payments to the Government of Iraq.** Not only were these side payments unauthorized, but it was an easy matter for Iraq to impose **"inland transportation" fees that far exceeded its actual transportation costs.**

By mid-2000, Iraq instituted a broader policy to impose generally a ten percent kickback requirement on all humanitarian contractors—including contractors shipping goods by land as well as contractors shipping to Umm Qasr. This broader policy was in addition to the requirement that contractors pay inland transportation fees. Iraq dubbed its more general kickback requirement as an "after-sales-service" fee. After-sales-service provisions often were incorporated into contracts as a way to inflate prices and permit contractors to recover from the United Nations escrow account amounts they had paid secretly to Iraq in the form of kickbacks. Contractors paid these kickbacks before their goods were permitted to enter Iraq. For ease of reference, this form of kickback is referred to throughout as an after-sales-service fee—even though Iraq often collected a ten percent fee without labeling it an "after-sales-service" fee or without inserting an after-sales-service provision in the applicable contract.

Many companies freely went along with Iraq's demands. **Others made payments to third parties or agents while disregarding the likely purpose of these payments, or perhaps unwittingly.** Indeed, the Committee calculates that more than 2,200 companies worldwide paid kickbacks to Iraq in the form of inland transportation fees, after-sales-service fees, or both.

11. As a matter of fact, this Volker Committee report goes on to acknowledge the fact that while many companies freely went along with Iraq's demand for kickbacks, many companies ignored the probable use of these payments, there were also the companies which were not aware about the end use of these payments and made these payments unwittingly. There were thus three categories of persons who paid the kickbacks (a) first, the persons who were all along aware that the payments as after sales service fee and inland transportation fees are in the nature of kickbacks and they were thus willing parties to these illegal gratifications; (b) second, the persons who had suspicion that the amounts paid as after sales service fees and inland transportation fees to may be used as kickbacks but they ignored these doubts; and (c) third, the persons who paid the amounts as after sales service fees and inland transportation fees under the *bonafide* belief that these payments are being made for the stated purposes. In our humble understanding, so far as category (a) is concerned, Explanation to Section 37(1) may hit the deductibility of impugned payments, but so far as categories (b) and (c) are concerned, Explanation to Section 37(1) cannot come into play. The onus of demonstrating that the case of an assessee falls in category (a), in our humble understanding, is on the Assessing Officer. That onus has not been discharged at all. The reasoning of our above approach is this. Explanation to Section 37(1) prohibits deductibility of any payment for any purpose which is an offence or which is prohibited by law. Even if we assume that a payment for kickback to Iraqi regime, which is prohibited by UN sanctions, could indeed be viewed as prohibited by law, would not render all payments towards after sales service and inland transportation fees as hit by Explanation to Section 37(1). The most significant aspect of the matter is the 'purpose' for which the assessee has made the payment. No doubt, when the payment is made for the purposes of illegal kickbacks, these payments invite disqualification under Explanation to Section 37(1), but when the assessee makes the payments for bonafide business purposes and such payments end up being used as illegal

kickbacks, in our considered view, Explanation to Section 37(1) will not be attracted. As far as the cases in category (a) are concerned, i.e. in a situation in which the assessee is a willing party to the illegal kickbacks, the onus is on the Assessing Officer to demonstrate so because an assessee cannot be asked to prove a negative i.e. that he is not a willing party to the illegal kickbacks. There must be some material to indicate that the assessee was aware that the payments by the assessee were to be used as kickbacks; a mere suspicion to that effect cannot suffice.

12. It is also important to bear in mind that the fact that the services were indeed rendered to the assessee. The fact that services were actually rendered to the exporters supplying goods under Oil for Food Program, in consideration for these payments is evident from the Volker Committee report itself. The services were rendered to the exporters but these services were rendered by the Iraqi regime and the money was passed by the front companies to the Iraqi regime. Even the Volker Committee report, which constitutes foundation of the impugned disallowances, has made following observations in support of this proposition:

In fact, all transportation services for which Alia received payment from humanitarian suppliers were provided by employees of the Government of Iraq. Transport of goods arriving at Umm Qasr was provided by trucks from the Ministry of Transportation or the Iraqi Grain Board ("IGB").

(Page 304 of the report)

Vessels berthing at Umm Qasr required the approval of the Iraqi State Company for Water Transport ("ISCWT") before being permitted to discharge. ISCWT was one of over a dozen SOEs overseen by the Ministry of Transportation and Communication ("Ministry of Transportation"). Under Iraqi law, ISCWT had exclusive authority for all activity at Iraqi ports. Its official function was to arrange and authorize the unloading of cargo and to act as a marine agent for ships carrying procured goods. In addition, it represented to the United Nations that it coordinated transport to internal warehouses and informed Iraqi end-users of inbound goods. However, ISCWT employees did not themselves actually participate in the discharge

and handling of cargoes. The Iraqi State Company for Ports, another SOE within the Ministry of Transportation, assumed that responsibility.

(Page 264 of the report)

If ISCWT had not received confirmation of a supplier having paid into an Iraqi-controlled bank account, it generally would not permit discharge of the supplier's cargoes. In such circumstances, the supplier or vessel chartering company incurred demurrage of thousands of dollars a day. One supplier interviewed by the Committee recalled that a supplier's failure to pay fees, even on just one contract, resulted in large demurrage and prevented the vessel's entire contents from being offloaded

(Page 272 of the report)

(Emphasis by underlining supplied by us)

13. It would thus seem that, even as per Volker Committee report, the services were indeed rendered for the commission payments paid by the exporters under the OFFP, but the services were rendered by the Iraqi regime itself, rather than the commission agent to whom commission payment was made, and the charges for these services were quite disproportionately high vis-à-vis the local costs.

14. None of the above reasons, even if be valid and correct, affect the deductibility of commission payments in the hands of the assessee.

15. The assessee has made payment for commission and has been rendered services in consideration of the same. As a matter of fact, it is not even revenue's case that no services have been rendered at all. The fact that services have been rendered by a party other than the agent to whom commission is paid is wholly immaterial so far as deductibility in the hands of the assessee is concerned.

16. As for the position that the payment was highly excessive vis-à-vis the local costs, even if that be so, that aspect of the matter does not affect the deductibility in the hands of the assessee either. The assessee is

concerned with commercial expediency of the said payment and not with what are the actual costs incurred in rendering the services for which the payment is made. As we have seen earlier in this order, from the extracts of the Volker Committee report itself, it was absolutely necessary for the assessee to make the impugned payments and, in any event, the commercial expediency of these payments has not even been called into question by the Assessing Officer. The case of the revenue is confined to invoking the Explanation to Section 37(1).

17. The objections to the said commission payments do not, therefore, are not therefore sustainable in law, so far as deductibility under section 37(1) is concerned.

18. A lot of emphasis has been placed by the CIT(A) on this Tribunal's decision in the case of TIL Ltd (supra). However, as we have decided the matter on merits and on the first principles, we see no need to deal with the said judicial precedent. Our reasoning could be different than the reasoning adopted by the CIT(A) and that adopted by the coordinate bench in TIL's case (supra), but then our conclusion is the same as arrived by the CIT(A) and by the coordinate bench. It is this aspect of the matter which is material for the present purposes.

19. In view of the above discussions, as also bearing in mind entirety of the case, we approve the conclusions arrived at by the CIT(A) and decline to interfere in the matter.

20. As we part with the matter, we must make it clear that our references to the Volker Committee report were only with a view to analyse as to whether even if everything stated in the Volker Committee report is taken as correct and this report is taken as an admissible evidence, will the deductibility of expenses in the hands of the assessee

will be hit by Explanation to Section 37(1). However, to what extent this report can be relied upon in income tax proceedings is still an open question. We leave it at that.

21. In the result, the appeal is dismissed. Pronounced in the open court today on 31st day of May, 2012.

Sd/xx
Mahavir Singh
(Judicial Member)
Kolkata, the 31st day of May, 2012

Sd/xx
Pramod Kumar
(Accountant Member)

Copies to : (1) *The appellant*
(2) *The respondent*
(3) *CIT*
(4) *CIT(A)*
(5) *The Departmental Representative*
(6) *Guard File*

By order etc.

Assistant Registrar
Income Tax Appellate Tribunal
Kolkata benches, Kolkata

Laha Sr PS